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(The opinions expressed in articles in The Canadian Chartered Accountant are the opinions of the writers of the articles and are not necessarily endorsed by the Association.)

Editorial Comment

Third Published Index

The Editorial Committee brings to its readers this month the third index prepared in connection with THE CANADIAN CHARTERED ACCOUNTANT, the other two having been published in 1931 and 1935. It includes the contents of all the numbers of this Magazine published between July 1935 and June 1939—volumes twenty-seven to thirty-four—and in addition a list of contributors for this period. As might be expected in a publication such as this, there are particulars on current topics which in time lose their significance. A perusal of the index however shows that in these forty-eight numbers of the Magazine there have been published numerous articles on accounting, economics, finance and taxation which, with the summaries of court judgments on matters of professional interest to members, form an accumulation of valuable material for the library of the accountant.

Provision in Will to Pay Income Tax

An interesting conflict of views was disclosed in a motion brought before the supreme court of Ontario for construction of the will of the late Sir Albert Edward Kemp. In commenting on the judgment, the editor of the *Dominion Law Reports* points out that it is the first Canadian case upon the question.

The testator directed his executors to maintain his residence property for the benefit of his widow and to pay her a fixed sum monthly for expenses of maintenance of the houses and buildings. He also directed that the provision for his wife should be a first charge upon his estate and that any succession duties and all income taxes which might be payable in respect of the provision in question for his wife should be paid out of his estate by his trustees.

Lady Kemp was in receipt of other substantial income from the estate and had also both before and after the death of the testator an independent income from other sources, with the result that the additional income deemed to be received by her by reason of the provision in the will with respect to the residence property and the maintenance thereof increased the rate at which the higher portion of her income was taxed. It was contended on Lady Kemp's behalf that that portion of her taxable income derived by virtue of the provision in question should bear the highest rate of taxation applicable to any part of her income, and the single judge, before whom the application was first brought, gave effect to her contention. The court of appeal by judgment rendered on 27th March 1939 reversed this ruling however, holding that, as a separate levy was not made by the *Income War Tax Act* in respect of the several component parts of the taxable income, no distinguishable part of her income tax was computed upon that part of her income deemed to be received by virtue of the particular provision in the will. Accordingly, the principle adopted in England was followed, namely, to take a proportionate part of every dollar of the tax as payable in respect of each particular part of the income.

There was a further difficulty. The income tax paid by the trustees for Lady Kemp was deemed by the *Income War Tax Act* to be additional income received by Lady Kemp and, therefore, tax would be payable with respect to it. The court of appeal reversed the judgment of first instance, holding that it was impossible to read the words, "all income taxes which may be payable in respect of the said above provisions for my wife," as including an additional benefit not within the provisions of the clause giving Lady Kemp the use of the house and the maintenance thereof. In other words, the income tax payable on this additional income was not to be borne by the estate.

Accounting Practice and Legislation

It may be said that the provisions of the Dominion companies' act and of the companies' acts of the Provinces as to the form in which accounts shall be presented and concerning auditors and their duties represent only minimum requirements in those respects. To the practising accountant the reason is obvious. Because of the very nature of his work, legal requirements must lag far behind the professional standards of the public accountant.

In a memorandum submitted some time ago to the senate committee on banking and currency in the United States, George O. May, one of the distinguished members of our profession, explained the lack of statutory enactments in this respect, and his observations should help members to make this clear to the layman. The committee was at the time considering a provision of the securities exchange bill which was to confer on a regulatory body not only the power to prescribe the form in which accounts of corporations shall be presented but also how profits shall be computed. "I have stated, and it cannot be too often repeated," he said in opposing the provision, "that accounts necessarily represent the result of the application of appropriate accounting principles and judgments to facts. Upon the soundness of the judgment employed first in choosing and then in applying the guiding principles depends the value of the resulting accounts. Sound judgment can be based only on intimate knowledge and ample experience, and its exercise should be attended with responsibility . . . The idea that uniformity can be attained and the exercise of discretion rendered unnecessary by rules, however detailed, is entirely illusory. . . Uniformity necessarily means a uniformly low standard—indeed, laws can do no more than lay down minimum standards; higher standards can come only as the result of the recognition of ethical and moral obligations."*

From this memorandum and from many other references in Mr. May's book the inquiring member today is given a glimpse of steps in accounting development of profound interest. One of the regrets of our Editorial Committee is that few, if any, of the older members of the profession in Canada have taken the time or shown the inclination to record in our Magazine for permanent reference an account

*George O. May, *Twenty-five Years of Accounting Responsibility*, Vol. II, page 110.

of events and experiences which have turned out to be milestones in the history of our profession. Out of long lines of events, fresh in the memory of those of mature years, standards of practice have developed and precedents have been established, the history of which will be a closed book unless written before those taking part in such events have passed from the scene.

Much as this particular lack may be regretted we have reason to feel gratified in other respects. There is now in course of preparation a history of the provincial Institutes by a committee of each Institute which when completed will be a valuable addition to our reference library. There have been, moreover, events and happenings contributing to our professional development of which there is a permanent record. Reference books on the subjects of accounting and auditing cite a score or more judgments of the courts in this and other countries respecting auditors and their duties and responsibilities. By the publication in full of the judgments in such cases the profession receives an undoubted benefit inasmuch as the facts are instructive and the judgments themselves serve not only in some degree to supplement the accounting and auditing provisions of companies' acts, but also to impress still further upon the auditor the need of circumspection in the performance of his duties.

Report on Auditing Procedure

And there is a source—and a very important one—that must not be overlooked. In addition to the findings of the courts there are the reports of special committees of our profession and the pronouncements of public bodies or commissions on questions within the field of the accountant, all of which are publicly recorded. Because our profession in Canada draws from the experiences of public accountants of other countries and because of the growing application of universal accounting rules and conventions, we wish to draw the attention of our readers to two reports or findings which have been released by important bodies in the United States within the past month or so.

The first is on the subject of auditing, and we hereby acknowledge the kind permission of the American Institute of Accountants to publish in this issue the report of its special committee on auditing and procedure adopted by the Institute on 9th May last. The disclosures in recent months

of conditions existing in exceptional cases in that country have prompted the profession there to examine more critically accounting procedures, and this report is a statement of the best practice for the future in regard to such matters as the examination of inventories, the examination of receivables, the appointment of independent professional accountants and the form of the public accountant's report. The report of the committee speaks for itself and we feel sure will be read with great interest by Canadian accountants.

The Interstate Hosiery Case

The second reference is to the recent findings and opinion of the Securities and Exchange Commission of the United States in the matter of Interstate Hosiery Mills* and are worthy the attention of all members of the profession.

The case is an unusual one and was a proceeding under the Securities Exchange Act commenced by an order alleging that the Commission had reason to believe that the financial statements filed by this company with the Commission for the years 1934, 1935 and 1936 were false and misleading. Following a public hearing the examiner found that the statements were false as charged and that both the registrant and the public accountants who had prepared and certified the financial statements were at fault. According to the examiner's findings the annual financial reports of the company "included an overstatement of 'gross profit on sales' in each year covered by the statements and a resulting cumulative overstatement of the balance-sheet figures for cash, accounts receivable, inventory and surplus." These annual reports containing the overstatements were certified by Homes and Davis, a firm of certified public accountants, and the falsifications were brought about—strange as it may sound—by arbitrary changes made by the supervising senior accountant on the staff of this firm. There was no evidence of complicity in the falsification by any employee of the hosiery company or by any partner of the public accounting firm, and the motive of the senior accountant for this misconduct, observes *The Journal of Accountancy*, remains mysterious—a mental aberration is the only explanation that has been forthcoming.

*A complete report of the findings of the Commission is published at pages 321-332 of *The Journal of Accountancy*, May 1939, the publishers' address of which is 13 East 41st Street, New York City.

Responsibilities of Auditors and of Management

We shall not give all the details of the case as they may be read in the reference libraries of the Provincial Institutes. The two main issues in the Commission's report to which we wish to draw attention were whether the accounting firm had exercised due care in reviewing the work of their employee, and whether the management of the corporation should have discovered errors in its financial reports. On the first point the Commission states as follows:

> We think it is self-evident that the review upon which an accounting firm assumes responsibility for work done by subordinates must be more than a series of perfunctory questions as to the performance of particular items in an audit program. Nor should explanations of unusual items be accepted by a reviewer without support in detail from the working papers. As a matter of principle, a review should, it seems to us, be designed with two objectives in mind: first, to insure the integration of the original work papers with the financial statements; second, a searching analysis of the ultimate facts developed in the course of the actual audit. An adequate review with the first purpose in mind should serve not only to disclose intentional or accidental misstatements, but should also serve as a method of internal check and control on the work of the firm's subordinates. This branch of the review, it seems to us, need not necessarily be carried out by a partner, but should at least be done by one well versed in the procedures adopted by the firm and in the general principles and terminology of auditing and accounting. If not a partner of the firm, such review should, in our opinion, be made by persons who are independent of those actually performing or supervising the audit work, as well as of those who prepared the draft of the financial statements. The second branch of the review is designed to enable the accounting firm to interpret intelligently the figures it has obtained and to which it is to certify. This part of the review should, it seems to us, be made by a person, preferably a partner, qualified by his knowledge of sound accounting principles and his familiarity with the accounting phases of the industry and the more important problems of the particular company. In this manner the facts ascertained by competent employees can be subjected to the independent and broader judgment of a more experienced person who can, by searching inquiry of the supervisor or senior and by examination of significant items in the work papers and schedules, reach an informed judgment both as to the adequacy of the audit work done and as to the integrity and clarity of the financial statements themselves. We are

satisfied that a review along these lines would have exposed the irregularities in this case.

The Commission also adds that "if an accountant is permitted to do original work, the whole purpose of the audit is lost."

On the second issue, the Commission gave as its opinion:

The duty to compare the Homes & Davis reports with the internal reports follows not only from the obligation to test the accuracy of the latter, but also from the obligation of the management to use all available means of assuring the correctness of its public financial statements. It is of course true that Homes & Davis were employed to check upon the internal employees, not *vice versa*; yet until all inconsistencies between the reports received from these two sources were satisfactorily explained, both sets of data were open to question.

Interstate's brief makes much of the confidence which the management "reasonably" reposed in Homes & Davis. The fundamental and primary responsibility for the accuracy of the information filed with the Commission and disseminated among the investors rests upon management. Management does not discharge its obligations in this respect by the employment of independent public accountants however reputable. Accountants' certificates are required not as a substitute for management's accounting of its stewardship, but as a check upon that accounting. In our opinion, the conduct of Interstate's management in respect of information which was to be the basis of reports submitted to stockholders and to the New York Curb Exchange and the Commission indicated a complete abdication of responsibility. They brought to bear upon the figures presented by their auditors no judgment of their own, no test from their independent acquaintance with the company's affairs, none of the purposeful skepticism which every author of a public financial statement should direct at his material.

Form of Published Accounts

We have the privilege of bringing to readers this month the interesting and helpful suggestions of Mr. Russell Kettle, F.C.A., on the form of published accounts. The subject of his lecture is one that engages the attention of our members every time they are called upon to add their reports to the audited balance sheets of their clients. The old contention of directors that a minimum of information in the annual published accounts is desirable in that it prevents competitors learning too much about their com-

pany's affairs is gradually losing weight. "The objective of the published accounts," as Mr. Kettle puts it, "is to provide within short compass effective means of enabling the shareholders clearly to assess and thus form an opinion upon the financial position and results and not to satisfy each and every inquiry on the part of individual members." As the Editorial Committee expects to receive requests from time to time for a copy of the lecture, a number of offprints is being made.

THE ACCOUNTS AND AUDIT OF A FIRE INSURANCE COMPANY

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IN THE following article, there is no attempt to lay down a complete plan of the accounts, but rather to discuss briefly some of the items peculiar to a fire insurance company, and to indicate an audit procedure for their verification. Moreover the article will be confined to a consideration of a company operating under Dominion charter, subject to the Canadian and British Insurance Companies Act, 1932, and carrying on the business of fire insurance only.

Revenues

(a) New Business—As applications are received from the agencies, they are passed to the underwriting department for approval. Here the application is scrutinized for rating, premium, classification, insurable interest, total amount of insurance, past history, etc., and when approved is passed on to the accounting department for numbering and entry in the Premium or Policy register. This procedure may be slightly altered to provide for "recording" agencies that write their own policies in the field and forward to head office a duplicate application. The Premium record is the counterpart of the sales recapitulation in the ordinary industrial or commercial firm. In view of the great volume of detail work involved and the necessity of keeping an accurate record of premiums and amounts of insurance written as between one-, two- and three-year plans and as between business written in each province, this book may best be written by a bookkeeping machine. As the application has already passed through the commissions department and has the agent's commission clearly marked on it, the machine operator records the policy number, name of insured, location, amount, premium and commission. In one operation of the machine, the premium register is written, the debit to the agent's account for the premium and the credit for the commission is posted, and the statement of the agent's account which is mailed to him at the end of each month is prepared. Another very satisfactory method is that whereby the machine operator, in the one operation, prepares a set of cards, one of which when filed

by drawers and withdrawn upon payment, forms the agent's ledger.

(b) Renewals and Endorsements—From the card files of insurance in force, cards are withdrawn usually two to three months in advance of expiry date. The practice among companies varies as to how often they extend the period of the policy, but in all cases they renew by certificate in each of the intervening years. Numbered renewal receipts should be prepared in duplicate and entered in the premium register in the same manner as a new policy, which is in the effective month. Endorsements calling for additional premium to be paid by the assured may be treated in a similar manner.

(c) Reinsurance Ceded by other Companies—It is the practice of fire insurance companies to have reinsurance agreements with other companies whereby they accept automatically all reinsurance offered, provided the other company has accepted the risk. Once each month, the ceding company furnishes to the company assuming, a bordereaux which shows the detail of each risk. Individual certificates are issued to the ceding company, but as the whole premium will be collected from the ceding company, the bordereaux is entered in the premium register for the total amount. Thus, the agency ledger contains an account for each ceding company just as if that company were an agent, which in fact it is.

When (*a*), (*b*) and (*c*) above are recorded and totalled for the month the columns so totalled form the basis for the general ledger posting

Dr. Agents' ledger control (Gross premiums less commissions)

Dr. Commissions

Cr. Gross premium income

From the standpoint of audit, (*a*), (*b*) and (*c*) above present a problem more tedious than difficult. Provided a proper internal check, the auditor can satisfy himself as to the premium income by random tests. Groups of new applications should be checked to the premium register for number, premium and commission. Special attention should be given to the calculation of commissions to determine that such are in agreement with the agent's contract. The company's regulations as to maximum amounts accepted on

individual risks should be known, and policies issued in excess of this amount should be checked for reinsurance. (See paragraph (*b*) under Expenditures). Duplicate copies of renewal certificates issued may be checked in the same manner by accounting for numbers, calculating agent's commission on the renewal basis, and as before, if the risk exceeds the maximum of the company, by seeing that reinsurance is placed for the balance. The reinsurance bordereaux from the ceding company represents an original invoice and requires no further check than seeing that it is properly recorded in the premium register. This check, however, should be supplemented from time to time by a test of the duplicate numbered copies of the reinsurance certificates issued to the ceding companies.

(d) Cancellations and Rebates — Cancellation may be at either the request of the assured or of the company. If of the assured the policy or renewal receipt for the unexpired portion of the contract must be returned. If at request of the company, registered notice of cancellation must be given and the evidence of this notice should be attached to the application which will be filed in numerical order. These are listed in a rebates and cancellations book which is simply the reverse of the premium register showing the "in force" amount and the premium involved, in addition to the cash return premium and the return commission. The totals of this record for the month will be posted as follows:

Dr. Rebates
    Cr. Commissions
    Cr. Agent's ledger (Gross rebates, less commissions)

Expenditures

(a) Claims—The accounting involved in recording the claims on the company is very simple. The cheque register should contain columns for both claims and adjustment expense so that these two items will be segregated. Claim papers, such as the company's proof of loss form, the adjuster's report, the report to the provincial fire marshal and other correspondence constitute the claim file which is used as a voucher by the auditor. However, the auditor's work on the claims does not end when he has vouched them. All claims under contracts which have been reinsured represent an item of income, and the amount to be recovered

from other companies should be closely checked to see that it is received. The total of such amounts should be charged to an account in the general ledger "Amounts due from reinsuring companies on losses paid" and receipts credited so that control is achieved. The auditor should also see that no reinsurance is overlooked. A group of the larger claims should be checked back to the applications to see that all reinsurance has been reported on the claim voucher. At the end of each fiscal period, every company is faced with the problem of setting up a reserve for unsettled and unreported claims. No definite rules can be laid down but a very close estimate can be made from the reported claims, combined with past experience on volume of claims. In practice it is found that owing to the rapidity with which claims are reported by the middle of the following month all claims pertaining to the period in question will be known. The share of the unsettled claims of reinsuring companies should be considered and treated as an asset.

(b) Reinsurance Expense—A considerable item of expense to any company is the cost of reinsuring itself against unduly large losses. As mentioned previously, the company usually enters into reinsurance agreements with other companies to take care of their excess risks. The auditor should inspect the reinsurance agreement and see that the company follows it and does not leave itself open to unduly heavy losses. On the issuance of new or renewal contracts for larger amounts than it is the company's policy to insure, individual certificates are made out for each risk reinsured. These are listed on a bordereaux each month and forwarded to the reinsuring company. The bordereaux to all companies when listed in a suitable record form the basis for the entry.

Dr. Reinsurance premiums
    Cr. Commissions
    Cr. Unpaid reinsurance premiums

Cancellations of reinsurance may be listed at the same time and combined with the ceded listing to form a net entry. Payments of premiums (net) to the reinsuring companies will be made once monthly and charged to the unpaid reinsurance premiums account, thus cancelling the liability set up. The audit of the reinsurance bordereaux will involve work as suggested in paragraph (*c*) under Revenues.

(c) Taxes—Insurance companies operating under Dominion registry are required to pay not only federal taxes, but provincial taxes in each jurisdiction in which they operate. Briefly these taxes may be outlined as follows, but for exact details reference should be made to the respective statutes.

In the majority of jurisdictions the taxes are levied as a percentage of (a) gross premiums written in that jurisdiction, less cancellations, rebates, and reinsurance premiums paid, and (b) a fire marshal's tax levied on the net fire business written in that jurisdiction.

Federal: 1% of (a);

Prince Edward Island: A flat amount of $225.00 per annum if the head office of the company is outside the province and $100.00 if the head office is inside the province;

Nova Scotia: 2½% of (a) with a minimum of $100.00, and ½% of (b);

New Brunswick: 3% of (a) with a minimum of $150.00, and ½% of (b);

Quebec: 1% of (a) with a minimum of $250.00, and ¼% of (b);

Ontario: 1⅔% of (a), and ⅓% of (b);

Manitoba: 3% of (a), and ⅓% of (b);

Saskatchewan: Graduated scale of 1% to 2% on (a) plus 50% of the tax with a minimum of $100.00 for companies whose capital does not exceed $100,000.00, otherwise a minimum of $175.00, and ⅓% of (b);

Alberta: 2% plus 10% of tax on (a), and ⅓% of (b);

British Columbia: 2¼% on (a), and ⅓% on (b).

In addition to the above, there are levied provincial license fees varying from $200.00 to $600.00. From the above it may be seen why it is necessary to keep subsidiary records classifying each policy between jurisdictions.

Returns

According to section 65 of the Canadian and British Insurance Companies Act, not later than March 1st in each year, all companies registered thereunder must file a statement of affairs as of the 31st day of December, in such form as may be determined by the Minister of Finance. It would

serve no purpose to list in detail the items contained in the report prescribed but brief comment is made here on a few of them.

(a) Real Estate—The item of real estate may be divided into two groups, the first being that of real estate held for the company's own use. Treatment of this item seems to vary widely and to the auditor accustomed to involved depreciation schedules and income tax regulations, provides a refreshing respite. The return simply calls for real estate to be valued at book value and section 71 of the Act makes provision for companies that overvalue their holdings. As a result, although some companies may follow a cost less depreciation basis, a great many reduce the value of their real estate holdings through surplus to a nominal figure much below its true value.

The other group consisting of real estate acquired through foreclosure of mortgages and held for sale is usually carried at cost, unless of course such figure is in excess of any possible recovery, in which case a reserve should be set up.

(b) Investments—Owing to the fact that all insurance companies have on hand at all times surplus funds, a portion of which is in the nature of a trust, consisting of unearned premiums and reserves for the protection of policyholders, their investment policy is necessarily restricted by statute. Section 60 of the federal Act specifies in what securities insurance companies may invest their funds, and should be very familiar to the auditor. Unauthorized securities are not allowed as an asset in the balance sheet. For full details the above mentioned section of the Act should be consulted.

In view of the large volume of investments held by all insurance companies and the fact that they are for the most part held till maturity, it is customary, and from an accounting standpoint necessary, to amortize the values at which they are carried on the books. Each new investment will be represented by a card or page in the investment ledger, and amortization tables should be made up or secured from the vendor. It is here suggested that the most practical treatment of the amortization table showing the division of each interest receipt between interest and principal, is to enter it immediately on the ledger card or page for

the life of the security. Then as each payment of interest is received through the cash book, the credit to interest and the debit or credit to investment account can be determined by reference to the above mentioned ledger sheet. The increasing or decreasing book values of the investment are also listed on the same line, so that the posting of the investment ledger simply entails the entry of a cash book folio. To illustrate:

(1) Interest Due	(2) Amount	Cash Book Folio	(3) Interest	(4) Principal	(5) Book Value	(6) Par Value
					$10,500	$10,000
Feb. 1st, 1938	$500	2	$400	$100	10,400	
Feb. 1st, 1939	500	5	395	105	10,295	

Columns (3), (4), and (5) may be written up at the time of purchase. The above treatment has also an advantage to the auditor. Once it is seen that the amortization table is properly entered on the investment ledger, verification of the correct amortization figures simply involves calling the posting from the cash book to that ledger.

The valuation of investments by insurance companies is prescribed by the Act in section 67 where it states that in the annual statement required to be deposited with the department of insurance the bonds, debentures, and stocks shall be valued at market values but, when in the opinion of the Minister market values are depressed, he may authorize the use of values in excess of said market values. It should be noted that the statement calls for book values of bonds, debentures, and stocks, but from the total gross assets is deducted or added an amount sufficient to bring those values to market values. In the company's own statement for publication it is not suggested that this practice be followed. Where book values are below market values, the securities should be shown at book value with a notation of the market value. Where book values are above market values, investment reserves sufficient to reduce the book value to market value should be established and be deducted from the asset to which the reserve pertains. That is to say, the accepted accounting practice should be followed, e.g.

Bonds and debentures at book value (Market value $11,000)	$12,000.00	
Less Investment reserve...	1,000.00	$11,000.00

(c) Agent's Balances—Although the Act governing companies operating under Dominion registry does not so state, the auditor should confirm all balances due from agents by sending out the usual form of verification, asking to be advised of any differences. For balance sheet purposes, balances owing for a period in excess of ninety days are an unadmitted asset.

(d) Unadmitted Assets—Both the federal and provincial departments of insurance do not allow certain types of assets to be included in arriving at the surplus of the company. This type includes office furniture and fixtures, plans and maps, agents balances over ninety days, unauthorized investments and other sundry assets, which must be included in the unadmitted assets section of the balance sheet.

(e) Reserve of Unearned Premiums—At the termination of each accounting period, every fire insurance company has a liability under contracts which extend into the future. For this reason, it is necessary to calculate the reserve of unearned premiums, and in calculating this reserve all business written in any year is treated as though it had been written on July 1st. Accurate records of business written and cancellations classified as between one-, two- and three-year business must be available. For example, in calculating the reserve at 31st December 1938:

Premiums Written	Term	Unearned Portion
1938	1 year	1/2
1938	2 years	3/4
1938	3 years	5/6
1937	1 year	Nil
1937	2 years	1/4
1937	3 years	1/2

Where the total unearned premiums have been determined, the Act states that 80% of this figure shall be the reserve held. The 20% remaining is considered to be the company's commission, should it be necessary to reinsure all the outstanding contracts. In verifying the above calculation, the auditor must accept the unaudited subsidiary records of the company but by reference to the unearned premiums as they appeared in the calculation of a year previous, and by tying up the figures of new business and cancellations with the general ledger accounts, he can satisfy himself as to

their accuracy. If desired, greater accuracy may be had by calculating on a monthly basis.

The Auditor's Certificate

For companies operating under Ontario registry, the auditor's certificate is specified by section 318(a) of the Ontario Companies Act. However, for companies operating under Dominion registry, no particular form of certificate is required by statute, but reference is usually made to the fact that the calculation of the reserve of unearned premiums is in accord with the provisions of the Insurance Act.

In conclusion, two interesting and unusual sections of the Act deserve comment. Section 99 provides that every company must at all times maintain assets allowable under the Act to a value of at least 15% in excess of the unearned premium upon all its outstanding unmatured policies calculated *pro rata* for the time unexpired, together with the amount of matured claims and all its other liabilities of every kind. It should be noted that the Act states unearned premiums and not the 80% reserve figure, and that in calculating the assets the amount of investments in the shares of any other company transacting the business of insurance are excluded. The penalty for non compliance is cancellation of the company's certificate of registry at the discretion of the Treasury Board. It is also interesting to note that in addition to the usual company provision that no dividends shall be paid which will impair the capital, dividends shall not be declared which will reduce the assets below the above mentioned 15% or while the assets are below that figure.

Section 101 of the Act defines surplus as the excess of assets over the paid-up capital and liabilities and provides that until the surplus equals the liability in respect of all outstanding unmatured policies not reinsured, the company shall at the end of each year appropriate to surplus at least 25% of the profits of that year.

If the above article has thrown light, no matter how dimly, on some of the unusual features encountered in the audit of a fire insurance company, the writer feels that his purpose has been achieved.

A FEW REMARKS ON BALANCE SHEETS AND PROFIT AND LOSS ACCOUNTS*

By Russell Kettle, F.C.A.,
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WHAT a difference there is between listening to a speaker who expresses himself clearly and in logical sequence and to one who roams around his subject without any regard whatever for the order or method of his remarks. Both may be knowledgeable. But whereas one can lead his audience step by step to understand the facts he narrates and the conclusions to be drawn from them, the other only succeeds in giving a confused and often misleading idea of what he intends to convey.

The accounts submitted to shareholders, often with only an attenuated report of the directors, constitute the board's annual financial review for the information of their constituents, and the only means by which a large number of shareholders unable to attend the general meeting are able to follow the fortunes of their company. In spite of the improvement which has taken place in recent years in the form and substance of annual accounts, boards of directors can still be divided into the two classes of speakers to whom I have referred. I want you to look at the two specimen annual accounts in your hands. Both purport to represent the same financial position and results—the one (Appendix A) drawn up without any regard for clarity and order and the other (Appendix B) prepared to present an intelligible and easily understandable state of affairs. The directors who sign the first balance sheet—Messrs. U. N. Tidy and N. O. Changes—appear to possess the demerits of their names: to them change appears to be abhorrent and they seem to want to escape criticism by confusing the minds of the shareholders. However, two recently appointed directors—Messrs. V. Clear and U. P. T. O. Date—feel that the shareholders, whose capital they administer and to whom they are responsible, are entitled to more consideration: they have therefore insisted upon the accounts being re-

*A paper read before the Chartered Accountant Students' Society of London on 22nd March 1939 and reprinted from *The Accountant* (England) by courtesy of the proprietors, Messrs. Gee & Company (Publishers) Ltd.

vised, on the lines recommended by their auditors, of course, with the result shown in Appendix B.

In your examinations when preparing a balance sheet and profit and loss account to satisfy the inquiries of the examiner, you should remember that his mind, and the marks he gives, will be influenced in favour of the candidate who shows initiative and imagination in the form and grouping of the various items. A balance sheet should not be merely a mechanical summary of the balances on the books; it should be an intelligible summary to justify fully the view that it exhibits a true and correct view of the state of affairs. Of course, in practice it is not the duty of the auditor to prepare the accounts, and if they comply with the requirements of the law he cannot necessarily say they are not true and correct solely on the ground that their compilation is in unsatisfactory form or that certain desirable amplifications are omitted. But he can, and should, suggest improvements to the board.

Common Deficiences in Form of Published Accounts

Now in the accounts which I submit in Appendix A the narrative and the way in which various classes of assets and liabilities appear are actually based upon their treatment in a selection of accounts which are published. The accounts so compiled are open to the following criticisms:—

(*a*) They are cramped and printed in a cumbersome form, i.e. folded once in book form and again twice in the opposite way, necessitating concertina-like operations to disclose the accounts. You must all have heard the rustle of this performance at shareholders' meetings.

(*b*) The printing is poor, the same thickness of type being used throughout, thus failing to clarify and distinguish the main headings from their subsidiary narrative.

(*c*) No grouping of items is attempted, with the result that shareholders who take an intelligent interest must get out paper and pencil to ascertain the total of the fixed assets, the aggregate amount of the current assets and of the liabilities, the total accumulated reserves and the profit for the year

(*d*) When dealing with figures of any size shillings and pence are of no practical importance and their

omission gives more space and adds to clarity: the intimation "adjusted to nearest £" printed in quite a number of accounts seems to me to denote an over-cautious mind. In this connection the chairman's review of the accounts is often considerably lengthened by stating *in extenso* the figures down to the last penny, e.g. "Debtors amount to five hundred and forty-one thousand nine hundred and seventy-two pounds four shillings and two pence" instead of "Debtors total five hundred and forty-two thousand pounds." Further, shareholders are not interested in technical accounting terms and the mysterious hieroglyphics "Dr.," "Cr.," "To" and "By" add nothing to their appreciation of accounts and are better left out. The headings "Capital and Liabilities" and "Property and Assets" rarely cover all the items appearing on each side of a balance sheet—for example, "Depreciation Reserve" or "Preliminary Expenses" — and seem to be redundant.

(*e*) No comparative figures are given of the previous year. The intelligent shareholder is thus forced to bring with him to the meeting the previous year's accounts or to write in his own comparative figures. This is in fact usually done on the chairman's copy by the secretary. May I interpose here to say that some of the more enlightened public companies furnish as an annexe to their annual accounts certain financial data covering a period of years. I have included a *pro forma* example of such a record as Appendix C to the model accounts, which enables a shareholder not merely to see the financial position and results of his company for the current and past year, but its financial history and progress over a period. The submission of this financial record for a series of past years is compulsory in the case of certain statutory companies such as the main line railways and if and when the Companies Act is again under review, this is a matter which I think might well be considered.

Revised Form of Presentation

If you will now look at the revised accounts in Appendix B, you will see that these criticisms no longer apply. The

accounts are in book form, the printing is clarified, the items are suitably grouped, shillings and pence and accounting terminology are absent and comparative figures are supplied. Both accounts are built up from the same data, but with what different results. Almost the only thing unchanged is the name of the company and I am sure it will be obvious to you that even this in the accounts I submit has not the same meaning in both cases!

Perhaps we can now examine a little more closely the differences in treatment of individual items. I will first refer to what I may call the model accounts and then by inference or otherwise to corresponding items in the other accounts. Share capital authorized and issued is so arranged as to avoid duplication of the description of each class of share, the issues appear in order of priority and the fact that all consist of £1 shares is so stated once instead of five times. The avoidance of apparently trivial duplications like this is not unimportant and you will observe other like examples in the accounts before you. Next, there are gathered together all the reserves and the profit and loss account balance which the directors propose to carry forward after making transfers to reserves and providing for dividends proposed. An intermediate balance sheet total is struck at this point to show the aggregate of the capital, reserves and retained profit and loss balance which together represent the shareholders' capital and accumulations of profits invested in the business. Although dividends recommended by the directors are subject to approval by the shareholders and are not technically liabilities at the balance sheet date, the practice of providing for such dividends and showing the resulting balance of profits is now sanctioned by usage and has everything to commend it, i.e. it does show the liabilities additional to those otherwise stated which require to be met out of the assets at the date of the balance sheet and also the balance of profit proposed to be carried forward. The method of arriving at the final profit and loss balance is shown by the appropriation account and by this means deductions for transfers to reserve and dividends do not complicate the balance sheet. There is no need to repeat past history by showing, as is done in the original balance sheet, the appropriations from the profits of the previous year. Incidentally, it is difficult to appreciate why the practice still obtains of describing interim and final

dividends on ordinary shares as "Interim (or final) dividend for the half year at the rate of 8 per cent. per annum less income-tax." If paid in respect of a period of three months a rate of 16 per cent. per annum would look even more handsome. Dividends are declared and paid for, or on account of, the financial year, so why not be clear and say what both such dividends really are, namely, "Interim (or final) dividend of 4 per cent. less income-tax." In regard to reserves, it is no doubt elementary to you to know that they should not be described as funds. They may be fund accounts if represented by specific liquid assets, which is rarely so, but otherwise they should be called reserves or reserve accounts. You will no doubt observe, when comparing the two balance sheets, the added advantage of last year's comparative figures in that they not only afford comparison, but avoid the necessity of narrative to show additions to certain reserves and other items, the facts being self evident when read in conjunction with the appropriation account. As you will see, the reserves include an amount for taxation. The actual liability is provided under current liabilities, the taxation reserve is free at the date of the accounts, being a wise and prudent allocation of profits on account of future liability based upon profits already earned.

Treatment of Liabilities

Next come the two issues of debenture stock grouped to show the total debenture debt. The interest rates are printed in figures and not in words; the nature of the respective security, method of repayment and final due dates are given, with a note, in the case of the second issue, of its authorized amount, thereby indicating the company's additional borrowing powers. Not infrequently, however, the terms of redemption are too complicated to be dealt with in the balance sheet.

Last on the liabilities side there is a summary of liabilities (including proposed dividends) showing the total current indebtedness of the company. The extent to which liabilities should be grouped is a matter upon which opinions may differ except that debenture stock interest, being secured, and amounts due to subsidiary companies must, as you know, be stated separately. In this connection may I interpose to say that if, as frequently occurs, subsidiary companies lodge their surplus funds with their parent the

description "Deposits by subsidiary companies" conveys more than "Amounts due to subsidiary companies." The choice of appropriate words may put an entirely different complexion on the real nature of transactions. The showing of small items of liabilities (and also of assets), such as unclaimed dividends, seems to me to indicate a lack of the sense of proportion; their separate disclosure is of no importance or materiality to shareholders who look for substantial presentation. Straining at the gnat and swallowing the camel is an apt expression very often in relation to published accounts. The use of the term "Credit Balances" (and also "Debit Balances"), which one still occasionally finds, is meaningless and should be avoided as should also the word "Sundry."

Treatment of Assets

Will you now look at the assets side of the balance sheet. First we have the fixed tangible assets relegating goodwill—which may quite well justify its value—to the foot of the accounts. There is no real objection to it taking first place, but in this case the architecture of the figures is easier if it appears last; otherwise another column would be essential to retain the grouping and to show separate totals of each group.

The fixed tangible assets are shown at cost or valuation with accumulated depreciation as a deduction as opposed to net figures and both figures would, of course, be adjusted in respect of assets no longer in use. This method of statement appears to me to be sufficiently informative. It could, of course, be expanded in columnar form or by additions and deductions horizontally, requiring considerably more space, to show the cost to the date of the last balance sheet, additions, less sales, since, and by way of deduction, the accumulated depreciation to the end of the previous year and the current year's provision. The comparative figures show, however, the net increases or decreases in the fixed assets during the year and it should not be forgotten that the overburdening of accounts with detail is apt to defeat its object. Shareholders can become bewildered with a mass of information as well as by paucity of it. You will note a different treatment regarding the balance of £10,000 payable on a recently purchased property. I prefer to bring it into the books rather than deal with the commitment by

way of note; if the amount were substantial it would, if merely noted, materially affect the view of liquidity gained by deducting the current liabilities from the current assets.

Statement of Interests in Subsidiary Companies

Interests in subsidiary companies consisting of share capital and advances form a separate group of a hybrid nature not being easily classified either as fixed or current assets. It is obviously incorrect to give the impression, as is done in the original balance sheet, that shares in subsidiary companies are marketable, by grouping them with general investments. Further, the advances are of a different nature from debts and other amounts owing, the liquidation of which may be looked for in the ordinary course of business: they are in the nature of capital loaned to the subsidiary companies. Frequently, such advances are represented by capital expenditure in the accounts of the subsidiary companies and in that case it is desirable that that fact should be indicated by describing the item "Advances mainly represented by capital expenditure." However, in our balance sheet you will see that for the information of the shareholders a note is added giving a brief indication of the amount of the fixed and net current assets representing the share investment and showing that the net assets of the subsidiary companies figure in their balance sheets at £332,315 against the sum of £292,105 at which the shares are stated in the balance sheet of the parent company. It is also apparent from the statement that the advances are covered by current assets.

The remaining items, consisting of current assets, have been rearranged in a group. The expression "after making provision for bad and doubtful debts" still survives: Bad debts should be written off. The various items of cash need not be detailed.

Financial Position and Trend Should be Made Easily Ascertainable

Looking now at our balance sheet as a whole, we can see at a glance, which is impossible in the original account:—

(*a*) The Share Capital	£2,300,000
(*b*) The aggregate Reserves and retained Profits	635,403
a total of	£2,935,403

and the general nature and amount of the assets in defined categories which, after deducting the current and funded liabilities, represent the Share Capital and Reserves, namely:—

		£	£
(c) Fixed Assets		2,197,902	
(d) Interest in Subsidiary Companies		417,115	
(e) Current Assets	£1,542,936		
Less—			
(f) Current Liabilities	472,550		
resulting in net current assets of		1,070,386	
giving total tangible assets less current liabilities of			3,685,403
Deducting—			
(g) Debenture Stocks			1,750,000
there remain net tangible assets of			1,935,403
Adding—			
(h) Goodwill			1,000,000
we arrive at the net assets including Goodwill of			£2,935,403

Preference Shareholders can thus appreciate that their capital of £800,000 is covered nearly 2½ times by the net tangible assets, whilst Ordinary Shareholders will recognize that their capital of £1,500,000 is represented as to about 75 per cent. by net tangible assets and the balance by Goodwill.

We can also see from the Balance Sheet the extent to which the fixed assets have been depreciated to date, the financial position of the subsidiary companies as a whole, their profits not brought into account, and the market or computed value of the general investments. The comparative figures of the previous year themselves explain much that has happened in the policy of the board and the trend of the company's trading and other activities.

You may possibly have noticed a recent innovation adopted by a few companies which, instead of submitting their balance sheets in the ordinary form of a double-sided document, set out the various items in the form of a continuous narrative or review on the lines I have just indicated when summarizing our balance sheet, the details of the various groups of items being set out to make up the total of each group. The profit and loss account is dealt with in a similar manner. There are many cases, however,

where such a form of account may be neither practicable nor desirable in that it would be less intelligible than the ordinary type of balance sheet and profit and loss account owing to its length and cumbersome appearance.

Contrasts in Form of Presentation of Profit and Loss Accounts

We will now leave the balance sheet and consider the profit and loss account, about which there is usually more criticism on the part of shareholders on the ground of its abbreviated form and consequent paucity of information. In the revised form it is, as you will see, divided into two sections, first the account of the year's trading and secondly a statement of the available profits, including the carry forward from the previous year, and their allocation to reserves and by way of dividends. Apart from the requirements in the Companies Act for disclosure of directors' remuneration and the statement under Section 126 as to how the profits and losses of subsidiary companies have been dealt with, the extent of the information to be given is entirely in the discretion of the board. Even strict compliance with the two requirements I have mentioned may be farcical, quite uninformative and misleading—in fact a skilful non-disclosure. I think you will agree that the original account is untidy and confused; it does not show the profit for the year and the items on the debit side are partly in the nature of charges and partly dividend appropriations. Frequently, although not in this example, the profit for the year is made more difficult to ascertain by bringing into the account the balance from the previous year. You will note the fact stated in the narrative that the profit is arrived at after providing for expenses of management and sometimes this is expanded to "all expenses of working and management:" there could hardly be a profit before deducting such obvious expenses and it seems unnecessary to state this fact either in the profit and loss account or in profit certificates for prospectuses. The directors' proposals for final dividends will appear in their report and not be reflected in the accounts. The statement under Section 126 is almost valueless when unsupported by figures in the accounts and the wording used in the disclosure of directors' remuneration gives the impression that the figure given is the whole of the remuneration of the directors and not merely that part required to be stated.

Extent of Information to be Given in Profit and Loss Accounts

The extent to which directors should give detailed information of trading is a very debatable point. There are frequently very good arguments for reticence in disclosure of such details. But this should not prevent the submission of a reasonable account or the disclosure of abnormal items which materially affect the year by year results otherwise prepared upon a consistent basis. There are two items which may fluctuate considerably from year to year, viz. taxation and depreciation, and it seems reasonable that the charges under these heads should be shown. Then we come to the thorny question of treatment of profits and losses of subsidiary companies. Here I prefer such results to be incorporated in the accounts of the parent company (and if desired form part of the item of profit on trading), but there may be very good reasons for not doing so. The directors may think it unwise to take credit for the entire results of subsidiary companies in view of their state of illiquidity or for other reasons. But it should be borne in mind that the undisclosed extent to which subsidiary companies' profits are not distributed may have the effect of creating quite an erroneous impression of the year's profit of the undertaking as a whole and distort the trend of profits year by year. The subject is admittedly difficult in practice, but when replying to examination questions you can be an idealist. In the accounts I show by way of note the figures of subsidiary companies' profits which are comparable with the net profits taken credit for and in the balance sheet, also by way of note under the profit and loss account balance, the amount of undistributed profits of subsidiary companies carried forward. This information, with the summary of the financial position of subsidiaries in the balance sheet is fairly comprehensive. If on the other hand there were good reasons for not disclosing the results of subsidiary companies, a note of the net amount of their profits or losses for the year not dealt with in the parent company's accounts would meet the criticism I have made. But the statement under Section 126 in the original accounts that the profits have been taken credit for "only" to the extent of dividends implies substantial undrawn profits which is far from correct when one can see, from the revised accounts, that £30,237 is taken credit for out of

£33,616. The disparity between the combined profits of a parent and its subsidiary companies and the profits of a parent company including only such results of subsidiary companies as it incorporates in its accounts is sometimes apparent by comparing in a prospectus the two reports of the accountants giving, firstly, the group profits and, secondly, to meet statutory requirements, the profits as shown by the parent company's accounts.

Necessity for Adequate Information to Form Proper Conclusions as to Year's Results and Trend

Now we come to the conclusions which can be drawn from the original and revised profit and loss account. The year's profit in each case is the same. But the original account fails to disclose facts which have an important bearing on the final result and the trend of the business as evidenced by a perusal of the revised accounts. Although the profit of the previous year, namely, £155,177, was only slightly less than the profit of £161,102 for 1937, the results do not in fact justify the general impression which the original accounts give, that normal trading has been well maintained. On the contrary, as shown by the revised accounts, the profit on trading after providing for directors' fees and depreciation was actually less by about £42,000 and whilst dividends, less loss, from subsidiary companies were nearly the same, the results of subsidiary companies revealed a decline of about £34,000 so that the results of trading were actually about £76,000 less favourable than those of the previous year. Further, to the extent of about £48,000 there is a somewhat fortuitous profit on sale of investments—merely indicated in the narrative in the original accounts without disclosure of amount—which goes to offset the decline in trading profits. You will, therefore, appreciate the importance of a consistent basis of disclosure. Consistency of treatment must, however, be tempered by a sense of proportion: for example, a profit on realization of investments of £100 would be unimportant in relation to the figures as a whole.

The shareholders, having before them the profit and loss account in the revised form, can now consider the year's results in relation to their investment, i.e., preference shareholders will see that their net dividend (£36,000) was covered over four times and the ordinary shareholders that

their net dividend of £90,000 compared with profits available of £125,000, excluding the amount of £25,000 allocated to debenture redemption—which might, but has not been dealt with to reduce *pro tanto* the normal charge for depreciation—and the small undistributed profits of subsidiary companies. Looked at from the point of view of the company as a whole the profit for the year of £236,000 (that is £161,000 shown by the profit and loss account plus income-tax £50,000 and debenture redemption £25,000, ignoring the small undistributed profit of subsidiary companies) represents about 8 per cent. on the total share capital and reserves of £2,935,000. These calculations, however, are based upon the available profit for the year, which includes a large non-recurring surplus of £48,000 from sale of securities approaching in amount one-third of the balance of profits: due weight should, of course, be given by shareholders to this important feature when considering the question of security of income. The comparative figures of the previous year, due regard being paid to exceptional items, can be contrasted in a similar way and if financial information for a series of years is given in the form of Appendix C, a very useful view can be formed of the capital and income merits of the two classes of share capital.

I have, of course, compiled my examples of accounts to emphasize the points I wished to make. Accountants have not all the same ideas as to grouping and tabulation, but provided the main features I have outlined are brought out clearly, the substance of my general criticism will be met. Refusal on the part of a board to adopt the auditors' suggestions of clarifying and amplifying the accounts does not in itself justify a qualified report if no questions of principle are at stake, bearing in mind in this connection both a sense of proportion and a proper interpretation of the requirements of the law, even if such interpretation falls short of what may be considered by auditors or shareholders to be desirable.

Limitations of Accounts: Rights of Individual Shareholders to Further Information or Responsibility of Directors to Shareholders as a Whole

In conclusion I should just like to say this. It is not in practice always so easy to deal with these problems as it is in examinations when the academic accountancy ideal can

be successfully followed. The considered views and opinions of a responsible board appointed by the shareholders to carry on the business must be taken into account and due weight must be given to them. Accounting is the handmaid of business and not its master and not least amongst the qualifications of an auditor is his ability to reconcile reasonable business considerations with proper accounting requirements in the interests of the shareholders as a body. Whilst many criticisms on the part of shareholders are justified, and it is difficult on occasions to appreciate why directors adopt what appears to be undue secrecy on matters on which shareholders are reasonably entitled to have information in the accounts, it should also be remembered that the necessarily restricted scope of balance sheets and profit and loss accounts does not permit of disclosure of more than a summary of the transactions of the year. In other words the objective of the published accounts is to provide within short compass effective means of enabling the shareholders clearly to assess and thus form an opinion upon the financial position and results and not to satisfy each and every inquiry on the part of individual members. The extent to which such inquiries should be satisfied at the annual general meeting is the responsibility of the board who must judge whether and to what extent it is in the interests of the shareholders as a body that supplementary information should be given at the instance of one shareholder not merely to the members present but as a consequence to the world at large. The bogy of the competitor as an excuse for withholding information is on occasions ridden hard: on the other hand critics are sometimes apt to forget that the owners of a so-called public company are a group of private individuals the internal working and details of whose joint business are entitled to the same protection and freedom from publicity as is enjoyed by a private firm. Limitation of personal liability is not the only limitation of rights and responsibilities of individual shareholders inherent in an investment in a public company.

I hope you have found interesting and helpful the suggestions I have made for improving balance sheets and profit and loss accounts.

APPENDIX A.

STORY TELLER & CO. LTD.

Dr. PROFIT AND LOSS ACCOUNT FOR THE YEAR TO 31ST DECEMBER 1937 *Cr.*

	£	s	d		£	s	d
To Directors' Fees	2,000	0	0	By Net Profit after crediting interest, dividends and surplus on realization of investments and after providing for expenses of management, bad and doubtful debts, taxation, depreciation and contingencies	257,164	4	9
" Interest on First Mortgage Debenture Stock to 31st December 1937, less Income Tax	29,062	10	0				
" Interest on Second Debenture Stock to 31st December 1937, less Income Tax	45,000	0	0				
" First Mortgage Debenture Stock Sinking Fund	25,000	0	0				
" Dividend on Preference Shares for half year to 30th June 1937, less Income Tax	18,000	0	0				
" Interim Ordinary Share Dividend for half year to 30th June 1937, at the rate of 6 per cent. per annum less Income Tax	33,750	0	0				
" Balance per Balance Sheet	104,351	14	9				
	£257,164	4	9		£257,164	4	9

STATEMENTS IN ACCORDANCE WITH SECTIONS 126 AND 128 OF THE COMPANIES ACT, 1929

The profits of Subsidiary companies have been included in the Profit and Loss Account of this company only to the extent to which they have been declared as dividends and a loss incurred by a subsidiary company has been provided for.

Directors' remuneration, including amounts received by directors from subsidiary companies, amounted to £3,750.

U. N. TIDY,
N. O. CHANGES, } *Directors.*

Dr. BALANCE SHEET—

Capital and Liabilities	£	s	d	£	s	d
To Share Capital Authorized—						
2,000,000 Ord. Shares of £1 each	2,000,000	0	0			
1,000,000 Six per cent. Cum. Pref. Shares of £1 each	1,000,000	0	0			
500,000 Shares of £1 each	500,000	0	0			
	£3,500,000	0	0			
" Share Capital Issued—						
1,500,000 Ord. Shares of £1 each, fully paid	1,500,000	0	0			
" 800,000 Six per cent. Cum. Pref. Share of £1 each, fully paid	800,000	0	0			
				2,300,000	0	0
" Five per cent. First Mortgage Debenture Stock				750,000	0	0
" Six per cent. Second Debenture Stock (secured)				1,000,000	0	0
" Interest accrued on First Mortgage Debenture Stock and Second Debenture Stock				18,281	5	0
" Reserve Fund as at 31st December 1936	180,000	0	0			
Add—Transferred from Profit and Loss Account	20,000	0	0			
				200,000	0	0
" Debenture Sinking Fund				50,000	0	0
" Dividend Equalization Fund				75,000	0	0
" Development Fund				30,873	6	9
" Sundry Creditors and Credit Balances including accrued charges and provision for Taxation and Contingencies				517,874	11	11
" Bills Payable				10,000	0	0
" Amount due to Subsidiary Company				7,931	2	2
" Unclaimed Dividends				212	13	6
" Profit and Loss Account—						
Brought forward from last account	166,428	6	3			
Less—Transfer to Reserve Fund £20,000						
Pref. Dividend for half year to 31st December 1936 (less Income Tax) 18,000						
Final dividend on Ordinary Shares for half year to 31st December 1936, at the rate of 8% per annum (less Income Tax) 45,000						
	83,000	0	0			
	83,428	6	3			
Add—Balance for year per annexed account	104,351	14	9			
				187,780	1	0
				£5,147,953	0	4

AUDITORS' REPORT TO

In accordance with the provisions of Section 134 of the Companies
and explanations we have required. In our opinion the balance sheet
so as to exhibit a true and correct view of the state of the company's
given to us and as shown by the books of the company. The deeds
been verified by us.

2 High Road, London.
30th March 1938.

A (Continued.)

31ST DECEMBER 1937 *Cr.*

Property and Assets				£	s	d
By Goodwill at Cost				1,000,000	0	0
" Freehold and Leasehold Land and Buildings at valuation in 1921 plus additions at cost, less sales and less amount written off and depreciation				1,372,102	2	4
Note.—There is a liability for balance of purchase price (£10,000) of a property recently acquired.						
" Plant and Machinery at Cost plus Additions, less Sales, and less Depreciation				814,800	1	3
" Furniture and Fittings at Cost, less Depreciation				1,000	0	0
" Investments—						
Subsidiary Companies at Cost less amount written off	292,105	1	4			
General, at or under Cost	109,333	2	1			
				401,438	3	5
" Stock in Trade and Stores as valued by the Management				762,486	8	2
" Sundry Debtors and Debit Balances including payments in advance, after making provision for Bad and Doubtful Debts				541,972	4	2
" Bills Receivable				14,000	0	0
" Loan				1,300	0	0
" Amount due by Subsidiary Companies				125,010	0	3
" Deposit Account at Bank				50,000	0	0
" Cash at Banks				63,417	4	1
" Cash in Hand				214	3	2
" Midland Bank, Ltd.—Dividend Account				212	13	6
				£5,147,953	0	4

U. N. TIDY,
N. O. CHANGES, } *Directors.*

THE SHAREHOLDERS

Act, 1929, we beg to report that we have obtained all the information
as above set forth, dated 31st December 1937, is properly drawn up
affairs according to the best of our information and the explanations
of the freehold and leasehold properties and the other securities have

WATCH, DOGG & Co.,
Chartered Accountants, } *Auditors.*

STORY TELLER

BALANCE SHEET AT

	Authorized	Issued		*1936*
	£	£	£	£
CAPITAL (in £1 Shares)—				
6% Cumulative Preference Shares	1,000,000	800,000		
Ordinary Shares	2,000,000	1,500,000		
Unclassified Shares	500,000	—		
	£3,500,000		2,300,000	*2,300,000*
RESERVES—				
General		220,000		*200,000*
First Mortgage Debenture Stock Redemption		50,000		*25,000*
Contingencies		85,000		*80,000*
Dividend Equalization		75,000		*75,000*
Development		30,873		*36,641*
Taxation—on account of future liability		81,000		*85,000*
		541,873		*501,641*
PROFIT AND LOSS ACCOUNT—				
Balance proposed to be carried forward per Appropriation Account		93,530		*83,428*
(Undistributed Profits of Subsidiary Companies amount to £40,210 (*£37,731*).)			635,403	*585,069*
			2,935,403	*2,885,069*
5% FIRST MORTGAGE DEBENTURE STOCK, 1967—				
Secured by a first charge upon the fixed assets and a floating charge upon other assets: repayable at par by annual drawings		750,000		*775,000*
6% SECOND DEBENTURE STOCK, 1990—				
Part of an authorized issue of £1,250,000 secured by a second charge upon the assets: repayable at 102%		1,000,000		*1,000,000*
			1,750,000	*1,775,000*
CURRENT LIABILITIES—				
Interest accrued on Debenture Stocks (less tax)		18,281		*18,516*
Balance of Purchase Price of Property		10,000		—
Trade and other creditors and Bills Payable, including provision for accrued charges		297,960		*354,512*
Taxation accrued to date		64,128		*29,720*
Amount due to Subsidiary Company (less dividend since declared)		7,931		*10,017*
Accrued Dividend on Preference Shares and proposed final dividend on Ordinary Shares (less tax)		74,250		*63,000*
			472,550	*475,765*
			£5,157,953	*£5,135,834*

REPORT OF THE AUDITORS TO THE

We have examined the above Balance Sheet dated 31st December
required. In our opinion such Balance Sheet is properly drawn up
affairs according to the best of our information and the explanations

2 High Road, London.
30th March 1938.

B.

& CO. LTD.

31ST DECEMBER 1937

	£	£	*1936* £
FREEHOLD AND LEASEHOLD LAND AND BUILDINGS			
at valuation in 1921 plus additions at cost	1,742,804		
Less—Depreciation and special amount written off in 1929	360,702		
		1,382,102	*1,313,071*
PLANT AND MACHINERY at Cost ...	1,378,002		
Less—Depreciation	563,202		
		814,800	*701,192*
FURNITURE AND FITTINGS at Cost	15,709		
Less—Depreciation	14,709		
		1,000	*1,000*
		2,197,902	*2,015,263*
SUBSIDIARY COMPANIES (WHOLLY OWNED)—			
Cost of Share Capital, less provision for losses	*292,105		*301,868*
Advances, including dividend since declared	125,010		*110,721*
		417,115	*412,589*

	£	£
**The Balance Sheets of Subsidiary Companies show:—*		
Fixed Tangible Assets		*310,304*
Current Assets	*184,716*	
Current Liabilities including advances from Parent Company, and dividend declared ...	*162,705*	
		22,011
Net Assets		*£332,315*

	£	£	*1936* £
STOCK AND STORES as valued by the Management	762,487		*793,017*
DEBTORS, LESS PROVISION FOR DOUBTFUL DEBTS	536,061		*496,777*
PAYMENTS IN ADVANCE	21,211		*19,764*
INVESTMENTS at Cost *less* Amounts written off	109,333		*251,720*
(Market or computed value—£121,672 (*£302,015*).)			
BALANCES AT BANKERS AND CASH IN HAND	113,844		*146,704*
		1,542,936	*1,707,982*
		4,157,953	*4,135,834*
GOODWILL at Cost		1,000,000	*1,000,000*
		£5,157,953	*£5,135,834*

V. CLEAR,
U. P. T. O. DATE, } *Directors.*

MEMBERS OF STORY TELLER & CO., LTD.

1937, and have obtained all the information and explanation we have so as to exhibit a true and correct view of the state of the company's given to us and as shown by the books of the company.

WATCH, DOGG & CO.,
Chartered Accountants, } *Auditors.*

STORY TELLER

PROFIT AND LOSS ACCOUNT FOR

	£	£	1936 £
DEBENTURE SERVICE—			
Interest (gross) on:			
5% First Mortgage Debenture Stock	38,750		*40,000*
6% Second Debenture Stock	60,000		*60,000*
	98,750		*100,000*
Redemption—amount required to be set aside out of profits in respect of First Mortgage Debenture Stock	25,000		*25,000*
		123,750	*125,000*
RESERVE FOR TAXATION ON CURRENT YEAR'S PROFITS—			
Income Tax	50,000		*60,000*
National Defence Contribution (9 months)..	7,000		—
		57,000	
BALANCE, BEING PROFIT FOR YEAR carried to Appropriation Account below ..		161,102	*155,177*
		£341,852	*£340,177*

PROFIT AND LOSS

		£	£	1936 £
AMOUNTS ALLOCATED TO RESERVES—				
General		20,000		*20,000*
Contingencies		5,000		
			25,000	—
DIVIDENDS (LESS TAX) PAID AND PROPOSED ON—				
6% Preference Shares		36,000		*36,000*
Ordinary Shares—				
3% Interim paid	£33,750		*3%*	
5% Final proposed	56,250		*4%*	
		90,000		*78,750*
			126,000	*114,750*
BALANCE PROPOSED TO BE CARRIED FORWARD				
Per Balance Sheet			93,530	*83,428*
			£244,530	*£218,178*

STATEMENT IN ACCORDANCE WITH

Profits of two Subsidiary Companies are included in the above has been made for a loss incurred by the remaining Subsidiary company.

& CO., LTD.

THE YEAR TO 31ST DECEMBER 1937

			1936	
	£	£	*£*	*£*
PROFIT ON TRADING		350,565		*391,242*
Less—Directors' Fees	2,000		*2,000*	
(The total Directors' remuneration required to be stated under Section 128 of the Companies Act, 1929 is £3,750.)				
Depreciation of Buildings, Plant and Machinery	91,660		*89,701*	
		93,660		*91,701*
		256,905		*299,541*
INCOME (GROSS) FROM SUBSIDIARY COMPANIES—				
Interest on Advances	5,000		*4,000*	
Dividends	35,000		*28,000*	
	40,000		*32,000*	
Less—Provision for loss	9,763		*1,576*	
		30,237		*30,424*
Note.—Profits, less loss, of Subsidiary Companies before charging inter-company interest and Income Tax— *1937* £33,616 *1936* *£67,155*				
INTEREST AND DIVIDENDS (GROSS) ON GENERAL INVESTMENTS ...		6,237		*10,017*
SURPLUS ON REALIZATION OF INVESTMENTS		48,186		—
TRANSFER FEES		287		*195*
		£341,852		*£340,177*

APPROPRIATION ACCOUNT

		1936
	£	*£*
PROFIT FOR YEAR per above Account	161,102	*155,177*
BALANCE FROM PREVIOUS YEAR	83,428	*63,001*
	£244,530	*£218,178*

SECTION 126 OF THE COMPANIES ACT, 1929

Profit and Loss Account to the extent of dividends declared. Provision Company which loss has been carried forward in the accounts of that

V. Clear,
U. P. T. O. Date, } *Directors.*

APPENDIX C.

STORY TELLER & CO., LTD.

Financial Record of Past 10 Years

	1928	*1929*	*1936*	*1937*
Issued Capital				
6% Cum. Preference Shares ..				
Ordinary Shares				
Reserves				
Profit carried forward				
Debenture Stocks				
Fixed Assets				
Interest in Subsidiary Companies				
Current Assets less Current Liabilities				
Goodwill				
Trading Profit				
Less—Depreciation				
Income from Subsidiary Companies				
Interest and Dividends				
Other Income				
Special items (enumerated)				
Less—Debenture Service ...				
Taxation				
Profit for Year				
Appropriation of Profit—				
Transfer to Reserves				
Dividends (less tax)—				
6% Preference Shares				
Ordinary Shares				
Rate	%			
Increase (Decrease) in carry forward				
Add — Undistributed Profits (less losses) of Subsidiary Companies				

Note.—Any necessary explanations such as an increase in capital during the period will appear by way of note at the foot of this statement and be referenced by way of asterisk to the items concerned.

EXTENSIONS OF AUDITING PROCEDURE*

REPORT OF THE SPECIAL COMMITTEE ON AUDITING PROCEDURE
AMERICAN INSTITUTE OF ACCOUNTANTS

RESOLVED: *That the council of the American Institute of Accountants hereby adopts the report of the special committee on auditing procedure dated May 9, 1939, as a statement of the best practice for the future in regard to the matters dealt with in the report. Be it*

FURTHER RESOLVED: *That the report be printed and distributed to members of the Institute and others interested.*

Adopted May 9, 1939

TO THE COUNCIL OF THE AMERICAN
INSTITUTE OF ACCOUNTANTS:

Gentlemen:

Pursuant to its appointment the special committee on auditing procedure has reviewed certain phases of auditing procedures and related matters. It has taken cognizance of recent discussions regarding such procedures, both within and without the profession, and now submits its report and recommendations relating to the following:

Examination of inventories

Examination of receivables

Appointment of independent certified public accountants

Form of independent certified public accountant's report.

Your committee has limited its consideration of auditing procedures and related matters to those cases in which financial statements are accompanied by a report and opinion of an independent certified public accountant. Accordingly, the report which follows should be read in the light of this limitation.

At the outset it is pertinent to state that, since the recent disclosure of conditions existing in exceptional cases, certified public accountants have been considering possible implications which may arise therefrom in relation to their practice. The committee desires to state its opinion that auditing procedure has kept, and continues to keep, pace

*The editorial Committee acknowledges the kind permission of the American Institute of Accountants to publish this report in THE CANADIAN CHARTERED ACCOUNTANT.

with the growth and development of industry and that the well established custom of making test-checks of accounting records and related data and, beyond that, reliance upon the system of internal check and control after investigation of its adequacy and effectiveness, has with very few exceptions proved sufficient for its purpose. Because of public interest and discussion in the press, there is a question now before the profession as to whether its procedures shall be extended. In order to consider the question intelligently there must first be some general understanding of certain fundamentals.

In the performance of his duties as auditor the independent certified public accountant holds himself out as one who is proficient in accounting practice and auditing procedure. The function of the independent certified public accountant is to examine a concern's accounting records and supporting data, in certain matters to obtain outside confirmations, and to require and consider supplementary explanations and information from the management and employees, to the extent necessary to enable him to form an opinion as to whether or not the financial statements as submitted present fairly the position and results of periodic operations. Generally speaking, his function is limited to reporting upon situations arising out of business transactions that have taken place in the past. In no sense is he an insurer or guarantor. In offering his opinion, the independent certified public accountant assumes heavy responsibilities. He must be skilled in his professional work and must have made a reasonable examination of the accounts in order to warrant his expression of an opinion. He must state his opinion clearly and unequivocally.

Management itself has the direct responsibility for the maintenance of an adequate and effective system of accounts, for the proper recording of transactions in the books of account and for the safeguarding of the assets of a concern. It is also charged with the primary responsibility to stockholders and to creditors for the substantial accuracy and adequacy of statements of position and operations.

In order to qualify himself to carry out his function the independent certified public accountant has completed a rigorous course of professional study and training as a background to the essential practical experience he must obtain, for it is only by study, training, and practical experience

that the independent auditor acquires skill in accounting and related matters. In the ordinary course of his day-to-day practice he encounters a wide range of judgment on the part of management, varying from true objective judgment to the occasional extreme of deliberate misstatement. He is retained to examine and report upon the affairs of a concern because, through his training and experience, he has become not only skilled in accounting and auditing but has acquired the ability and habit of considering dispassionately and independently the facts recorded in books of account or otherwise disclosed by his examination and because, as a result, his opinion provides reasonable assurance that a fair and adequate presentation of pertinent information has been made in the financial statements.

The independent auditor must also exercise his best judgment in determining the scope of his examination and in deciding whether the interests of stockholders and creditors justify the time and expense involved in the extension of any particular line of inquiry. Experience shows that, with few exceptions, the personnel of business organizations is honest. The discovery of defalcations has not been a primary objective of an examination incident to the issuance of financial statements accompanied by a report and opinion of an independent certified public accountant, although such discovery has frequently resulted. In a well organized concern the principal reliance for the detection of such irregularities is placed upon the maintenance of an adequate system of accounting records with appropriate internal check and control. It is the duty of the independent auditor to satisfy himself that the system of internal check and control is adequate and sufficiently effective to justify reliance thereon. To exhaust the possibility of exposure of all cases of dishonesty or fraud, the independent auditor would have to examine in detail all transactions. This would entail a prohibitive cost to the great majority of business enterprises—a cost which would pass all bounds of reasonable expectation of benefit or safeguard therefrom, and place an undue burden on industry.

In carrying out his work the independent certified public accountant must always be on his guard against collusive fraud and be alert in detecting any sign of such collusion. However, on the basis of his examination by tests and checks, he relies upon the integrity of the client's or-

ganization unless circumstances are such as to arouse suspicion, in which case he must extend his procedures to determine whether or not such suspicions are justified.

In the judgment of this committee the independent certified public accountant should not express the opinion that financial statements present fairly the position of the company and the results of its operations, and that they conform to generally accepted accounting principles, when his exceptions are such as to negative the opinion, or when the examination has been less in scope than he considers necessary. In such circumstances, the independent certified public accountant should limit his report to a statement of his findings and if appropriate his reasons for omitting an expression of opinion.

Turning now to consideration of the specific matters referred to at the beginning of this report, it may be noted in passing that, although it has not generally been considered normal procedure, in some cases independent certified public accountants have made physical test-checks of inventory quantities and have confirmed receivables by direct communication with debtors. Such physical tests of inventory, however, have usually been undertaken as an additional procedure under arrangement with the client, while confirmation of receivables by direct communication with debtors has been undertaken where the accountant thought it an essential or desirable step in a particular case or at the request of the client.

Your committee is of the opinion that recognition should be given to the widespread demand for an extension of auditing procedures with regard to inventories and receivables. However, it should be noted that additional expense to business will be involved in the added procedures, and business concerns which do not have them undertaken must recognize the necessity of disclosure of their omission.

Inventories

The added steps that may well be taken to give greater assurance with regard to inventory quantities will vary in different circumstances but, however extensive these may be, the training and experience of an independent certified public accountant do not qualify him as a general appraiser, valuer, or expert in materials. The public should understand that, while he can take steps to warrant the expres-

sion of his opinion as an accountant that stated quantities of merchandise are actually on hand, such procedure does not invest his opinion with a degree of authority which he does not claim for it, or impose upon him a measure of responsibility which the nature of his work does not justify.

Your committee believes that corroboration of inventory quantities by physical tests should be accepted as normal audit procedure. The manner and extent thereof will necessarily vary with the circumstances, because the independent auditor is justified in giving consideration to the effectiveness of the internal check and control as applied to book records and to the procedure of taking physical inventories.

In cases where the inventory is determined solely by means of a physical count at the end of the accounting period it will be necessary for the test-checks of quantities to be made at that time. In some cases it may be practicable and satisfactory for the independent auditor to be present at the time of taking the inventory to see that a method, carefully thought out and established, and providing adequate internal check and control, is in fact being followed. Another plan which would be satisfactory where the circumstances permitted would be for the auditor to encourage throughout the year the continuous taking and checking of parts of the inventories against stock records, or other book records, by employees independent of the stockkeeping departments, and for the auditor to examine in whole or in part the reports on these partial checks and to participate in some of them.

The general adoption of such added procedures regarding physical quantities of inventories may also necessitate procedural changes on the part of clients. So many corporations close their books upon a calendar year basis that your committee doubts whether the profession as at present organized can undertake to make physical test-checks adequately and satisfactorily on the last day of each year. Many corporations do not have adequate perpetual inventory records and greater use of them should be encouraged.

The extension of procedures regarding inventories would be greatly facilitated if each concern adopted its natural business year instead of the calendar year as its fiscal year, and introduced continuous well kept perpetual inventory records.

The proposed changes will take time to bring about, and your committee is of the opinion that in the meantime the profession may well be faced with the necessity of submitting qualified reports in those cases in which it has been impracticable to carry out the added procedures.

Taken in consideration with the foregoing discussion of audit procedures relating to inventories, your committee makes the following recommendations in respect thereof:

(a) That hereafter it should be generally recognized as normal procedure in the examination of a concern where inventories are a material factor, where the independent certified public accountant intends to report on the financial statements of the concern over his signature, and where

(1) such inventories are physically taken at the balance-sheet date or

(2) such inventories are physically taken at a date prior or subsequent to the balance-sheet date but within a reasonable time thereof, with adequate records supporting the interim changes in inventories,

he shall make such auditing tests and checks of the inventory accounts and records as may be feasible in corroboration of the representations of the concern relative to the inventories; also, he shall wherever practicable and reasonable make, or where the inventory taking is adequately planned and controlled observe the making of, physical tests by count, weight, or measurement, for the purpose of satisfying himself that the methods of inventory taking have been carried out effectively and for the purpose of testing the accuracy of the recording of quantities in the inventory records;

(b) That hereafter where inventories are a material factor, and a concern does not customarily take a physical inventory at the balance-sheet date but maintains well kept and controlled perpetual inventory records supported by: (1) a complete physical inventory at a date not coincident with the balance-sheet date, or (2) physical inventories of individual items from time to time so that the quantity on hand of each item is compared with the inventory record for that item at least once in each year, the independent certified public accountant shall wherever practicable and reasonable make, or, where the inventory taking is adequately planned and controlled observe the making of, physical tests

by count, weight, or measurement, at any interim date or dates selected by him for the purpose of satisfying himself as to the substantial accuracy of the perpetual inventory records so that they may be relied upon to support the inventory totals as shown on the balance sheet; and that such an examination be recognized as normal audit procedure;

(c) That hereafter, where the independent certified public accountant has not made, or observed the making of, physical tests by count, weight, or measurement, either because such tests in his opinion are not practicable or reasonable, or because he has departed from normal auditing procedure, he shall make suitable explanation or exception in reporting on the financial statements of a concern over his signature;

(d) That hereafter, in the case of inventories which in the ordinary course of business are in the hands of public warehouses or other outside custodians, direct confirmation in writing from such custodians is acceptable as a procedure in lieu of physical tests; except that where the amount involved represents a significant proportion of the current assets or of the total assets of a concern the independent certified public accountant shall make supplementary inquiries.

In making, or observing the making of, physical tests by count, weight, or measurement, the independent certified public accountant does not hold himself out as, or assume the responsibilities of, a general appraiser, valuer, or expert in materials.

Receivables

In regard to the question of confirming receivables by direct communication with the debtor, your committee makes the following recommendations:

(a) That hereafter, in cases where the aggregate amount of notes and accounts receivable represents a significant proportion of the current assets or of the total assets of a concern, confirmation of notes and accounts receivable by direct communication with the debtors shall be regarded as normal audit procedure in the examination of the accounts of a concern whose financial statements are accompanied by an independent certified public accountant's report; and that the method, extent, and time of obtaining such confirmations in each engagement, and whether of all

receivables or a part thereof, be determined by the independent certified public accountant as in other phases of procedure requiring the exercise of his judgment; and

(b) That hereafter, where the independent certified public accountant, for any reason, has not made such confirmation, he shall make suitable explanation or exception in his report.

Appointment of Independent Certified Public Accountants

Apart from the specific phases of auditing procedure which have been the subject of consideration, your committee is of the opinion that the method of appointment of the independent auditor and his status in relation to the client are subjects of great importance to stockholders and creditors.

Your committee suggests that the independent auditor should be engaged or nominated by the board of directors.

Some prominent corporations have adopted the practice of having the independent auditor elected annually by the stockholders. Other corporations have provided that the stockholders be given an opportunity to ratify the selection made by the directors.

Your committee believes that the auditor should be appointed early in each fiscal year so that he may carry out part of his work during the year.

Form of Independent Certified Public Accountant's Report

The services which independent auditors render usually culminate in a report, which may take varying forms. In some cases a detailed report is rendered accompanied by statements and supporting schedules; in other cases the report is limited to a concise statement of the scope of the examination and the related opinion of the independent auditor concerning the accompanying financial statements of the client. For present purposes the discussion is confined to the short form of auditor's report, which is sometimes described as a certificate. The terms "report," "report and opinion," and "certificate" have been used interchangeably. As uniformity is desirable the word "report" is recommended for general use and has been adopted in the following comments.

In January, 1934, the Institute issued a pamphlet entitled "Audits of Corporate Accounts," dealing with a standard form of auditor's report. The short form of report then recommended, and since widely adopted by the profession, met a long-felt need.

Developments during the five years in which the standard form of report has been used indicate the need of revision in the interest of clarity. If the revised short form recommended herein be adopted, the independent certified public accountant should recognize that in some cases it may not be altogether appropriate. For instance, there may be cases where the auditor may prefer to alter the first sentence of the standard short form, substituting some words to the effect that the accounting records (instead of the financial statements) have been examined. Obviously, also, it would be erroneous to mention internal control if none existed. Accordingly, while the proposed form is submitted as a standard, it is not prescribed or recommended for invariable use but should be adapted to the needs of the particular case. For example, the report may be used in connection with an examination covering a period of years, in which case a modification of language would be necessary. Also, in new engagements appropriate investigation relating to prior years will have to be made to justify the use of the short-form report. However, in the interest of reasonable uniformity it is recommended that the substance of appropriate phrases in the standard form be used unless inappropriate.

The major changes recommended pertain to the description of the scope of the examination, specifically to include reference to the system of internal control. The phrase "obtained information and explanations from officers and employees of the company" has been omitted because it is inherent in all auditing procedure to obtain information and explanations from officers and employees concerning the accounts, either as supplementing information obtained from other sources or as constituting the only available information on the subject. In the latter case, the auditor must decide, in view of all the circumstances, whether he should rely upon such information without disclosure of the source. The phrase in question has led to serious misconception as to the degree of reliance on such information and explanations. The statement "but we did not make a de-

tailed audit of the transactions" has been omitted from the revised form. It will be recalled that this clause was included in the standard form of 1934, in order to make clear that the auditor's usual procedure consisted of testing and sampling rather than a detailed audit. It is believed that the business and financial public now fully understand that, in a well organized concern, the detection of irregularities is primarily a matter of internal procedure, and that testing and sampling, to determine whether such procedure is adequate in scope and effective in operation, is the usual practice of the independent auditor. The negative statement disclaiming a detailed audit may, therefore, well be omitted. There has also been excluded the phrase "based upon such examination," as it is obvious that the independent certified public accountant can express an opinion only after he has completed the work set forth in the first paragraph of the report.

The revised short form of report consists of two paragraphs. The first contains a brief statement of the scope of the examination, and the second deals with the auditor's opinion on the financial statements of the client as a result of his examination.

In considering the independent certified public accountant's opinion the reader should bear in mind one of the most important underlying concepts of financial statements, viz., that normally many of the assets of a concern are not realizable in cash but are commonly stated at their historical cost or going-concern basis as figures which are usually greater than the realizable value in forced liquidation. Again, the true profit or loss of a concern can be determined with accuracy only over its entire existence. Therefore, in any attempt to allocate to specific periods profit or loss applicable thereto, it must be recognized among other considerations that, as many transactions are not fully completed within such periods, the result as shown must contain many estimates and approximations in the endeavor to present fairly the operating results of a period.

Assuming that normal procedures have been carried out it is considered to be neither necessary nor generally desirable to describe the details of the examination in this form of report. Any such details as are given should be included in separate paragraphs of the report. For example, reference may be made to procedures which the accountant has

adopted regarding the examination of inventory quantities, and confirmation of receivables by direct communication with debtors; also, it may be pertinent to mention the fact that certain portions of the auditor's work have been carried out at different times during the course of the year. This may be indicated by inserting the words "at times" in the first paragraph of the short form of report immediately after the words "by methods."

It should be borne in mind that the financial statements, with all supplemental descriptive and explanatory data, including footnotes, are regarded as representations of the client. It is upon all these representations that the independent certified public accountant renders his opinion. If he considers explanations essential or desirable, and they have not been made in the financial statements, it will be necessary for him to make such explanations in a separate paragraph of his report.

It is desirable as a general rule that exceptions by the independent certified public accountant be included in a paragraph separate from all others in the report, and be referred to specifically in the final paragraph in which the opinion is stated. Any exception should be expressed clearly and unequivocally, as to whether it affects the scope of the work, any particular item of the financial statements, the soundness of the company's procedures (as regards either the books or the financial statements), or the consistency of accounting practices where lack of consistency calls for exception.

It is worthy of repetition that the extent of sampling and testing should be based upon the independent auditor's judgment as to the effectiveness of internal control, arrived at as the result of investigations, tests, and inquiries. Depending upon his conclusions in this respect, the independent certified public accountant should extend or may restrict the degree of detailed examination. Consequently, in some cases it may be necessary to modify or omit reference to reliance upon the system of internal control. It follows also that where a detailed examination is made no reference to internal control is necessary.

It is contemplated that, before signing a report of the short-form type suggested, the independent certified public accountant will be satisfied that his examination is in conformity with the procedures and practices outlined in "Ex-

amination of Financial Statements," a bulletin published by the American Institute of Accountants in January, 1936, or in any subsequent revision thereof.

The report should be addressed to the board of directors or the stockholders if the appointment is made by them.

The description of the financial statements in both paragraphs should, of course, conform to the titles of the accompanying statements.

In consideration of the foregoing remarks your committee recommends the following short form of report:

Short Form of Independent Certified Public Accountant's Report

To the Board of Directors (or Stockholders) of the XYZ Company:

We have examined the balance-sheet of the XYZ Company as of April 30, 1939, and the statements of income and surplus for the fiscal year then ended, have reviewed the system of internal control and the accounting procedures of the company, and have examined or tested accounting records of the company and other supporting evidence, by methods and to the extent we deemed appropriate.

In our opinion, the accompanying balance-sheet and related statements of income and surplus present fairly the position of the XYZ Company at April 30, 1939, and the results of its operations for the fiscal year, and conform to generally accepted accounting principles applied on a basis consistent with the preceding year.

In conclusion, your committee desires to state that it has dealt only with the more important phases of auditing procedures and related matters which are the subject of current public interest. A more extensive review of auditing procedures is in process. In the course of its deliberations your committee has conferred with representatives of the following bodies whose interest might be affected by the committee's recommendations and has endeavored to keep them informed of progress in the work:

Advisory Council of State Society Presidents
Controllers Institute of America
National Association of Cost Accountants
National Association of Credit Men

National Association of Manufacturers
New York Stock Exchange
Robert Morris Associates
Securities and Exchange Commission.

Samuel J. Broad, chairman of the special committee to revise the bulletin "Examination of Financial Statements by Independent Public Accountants," and Edward A. Kracke, chairman of the special committee on inventories, have participated in all meetings of the committee.

Respectfully submitted,

SPECIAL COMMITTEE ON AUDITING PROCEDURE

P. W. R. Glover, *Chairman*
George Cochrane
George P. Ellis
Stanley G. H. Fitch
J. K. Mathieson
Norman L. McLaren
Maurice E. Peloubet
Walter A. Staub
Victor H. Stempf
C. Oliver Wellington

LAND SETTLEMENT TO REDUCE RELIEF ROLLS

AT ABOUT this time last year (May) Henry Ford, who has pioneered many developments in motor car manufacturing, but often advocated a return to some of the ways of living of a generation ago, sponsored a community farm plan under which over fifty unemployed youths were enabled to earn a reasonable daily wage for their farm work throughout the summer and at its close divide a profit made on the enterprise amounting to nearly $100 for each boy. While conditions in this instance were almost ideal, in that the farm chosen was located on a busy highway so that much of the produce could be sold to passing motorists and capital was not lacking to provide whatever equipment was needed for the farm—and best of all a job was waiting for each of the boys at the Ford factory at the end of the season— it would seem reasonable to suppose that a farm placement plan for unemployed persons would be of some assistance in reducing relief rolls.

This idea was mentioned in only a short paragraph in the report of The National Employment Commission, published in January 1938, but the various Provinces in cooperation with Federal authorities have adopted various plans to carry it into effect.

In the western provinces a scheme has been developed whereby single men on relief may be allotted to farms and the government supplies a small amount to the farmer which he in turn pays over to the reliefee. It would seem probable that these persons might displace presently hired men and thus aggravate the problem, but this does not appear to have happened.

The Dominion-Provincial Youth Training Plan includes in its program provision for farm training, so that the younger generation may not be unprepared if an opportunity is given to them for land settlement. In Saskatchewan, for example, at the provincial university a six-weeks' short course is provided. Twice a year one hundred young Saskatchewan farmers are paid $50 for transportation, board and books for the duration of the course. The course consists of four weeks' farm mechanics, each day consisting of three lectures and four hours of laboratory work such as carpentry, blacksmithing, tinsmithing, farm machine adjustment and repair, and engine overhaul, and two weeks of general agriculture, which includes lectures and laboratory periods on field and animal husbandry, horticulture, poultry, dairy, entomology, veterinary science and farm management.

The interest of the boys in these courses is evidenced by the fact that between five hundred and six hundred applications were received for each of the first two courses, out of which one hundred boys were selected on the basis of worthiness and need.

Lack of experience in farming has been the cause of failure in many land settlement schemes, and the Province of Ontario in embarking upon a farm placement plan intends to run no risk of failure because of this. Applicants must have previous farm experience and a proven desire to return to farm life; they must be physically fit and have employable children to assist with the farm work.

The applicant himself must find a suitable farm that can be rented within the terms offered by the government; that is, at not more than $200 per year for three years with

an option to purchase. Usually the applicant locates somewhere near where he has farmed before, and local conditions are known to him. Up to $600 will also be allowed to him for stock and equipment. Necessary direct relief assistance will be continued on a limited basis.

A plan such as this is limited in scope, perhaps not more than 200 families will be affected the first year, but it will enable authorities to test the feasibility of the plan so that it may be made available to many more who have indicated they are eager to take advantage of it.

There are real cash savings under such a plan, because shelter allowance is less, fuel allowance is less and the food allowance may also be less; but one of the greatest savings through such a plan cannot be measured in dollars and cents —that is the saving of the morale and self respect of the recipient of relief by giving him work to do and taking him off the relief roll.

G. R. G. Baker.

CORRESPONDENCE

(*Editor's Note:* There is a standing invitation to all members of our Association to contribute to the Correspondence Column of THE CANADIAN CHARTERED ACCOUNTANT. As Dr. Horace L. Brittain, who is Director and Secretary of the Citizens' Research Institute of Canada, has contributed to our pages on previous occasions, we invited him to make some observations on Public Finance, the subject of Professor Curtis' article in the May issue. We are pleased to publish this month both his letter and that of Mr. C. W. Leach.)

The Editor,
The Canadian Chartered Accountant.

Dear Sir:

I have read over with great interest the article by Professor Curtis on PUBLIC FINANCE in the May number of THE CANADIAN CHARTERED ACCOUNTANT and find myself in essential agreement with his position on most of the points raised.

I certainly would not write an article on Public Finance taking issue with the general position of Professor Curtis, although I might raise in this letter some queries on matters of detail.

While in Canada, as in the world in general, there have been great increases both in public expenditures and national income during the last half century and while it is true that this may not represent a serious condition, there were in Canada between the years 1926 and 1933 large increases in the percentages that taxation and expenditure formed of the national income. This was due to two factors, the increase in public expenditures (although tax collections did not increase) and the rapid decline in the national income after 1929. Even since the beginning of recovery of the national income, the percentages are still high, taxation in 1936-7 being in Canada about 21.7 and ex-

penditure, other than that on the post office, being about 25.5% of the national income. While governments naturally encounter tremendous resistance to any attempt to reduce the governmental "cost of living" to square with reduced national income, and while increased government expenditure and reduced taxation during a period of depression may often be quite justified, it is a question whether in many cases the "lag" might not have been shortened in the public interest by economies which could have been made without cutting essential services.

The chief causes of increased expenditure over fifty years are, as Professor Curtis says, increased war expenditures, increased social service expenditure (including welfare, public health and unemployment relief), increased educational expenditures and increased highway expenditures. I have not of course access to the data of Professor Curtis, but it seems to me possible that the proportions of the revenue which go to interest charges, war pensions, etc., of the last war and to the expenditures on the past war and present defence are somewhat overstated.

It is interesting also to note that during the depression, educational expenditure was the only one of the social expenditure group which declined during the depression and that even between 1926-27 and 1936-37 it increased in total only 2.34% and per capita actually decreased 11%. It is doubtful that school efficiency decreased proportionally. Apparently educational expenditures offered the line of least resistance. Possibly the "lag" would not have been so great if other governmental functions had been treated similarly.

There is another cause of the increase in public expenditure, and that is transportation deficits. These deficits varied between $65 millions and $100 millions between 1930-31 and 1937-38 even assuming that no element of cost is understated. It is very difficult to make the average man believe that nothing can be done without grave damage to the existing economy to reduce these annual deficits. There is evidence to indicate that the total debt properly chargeable to transportation is greater than the war debt. Annual governmental deficits at all levels of government and for all services which varied between $100 millions and $220 millions from 1930-31 to 1937-38 were largely added to the public debts and therefore to the current burden of taxation. To the extent that this represents waste and inefficiency, it adds to the real burden.

It seems to me that Professor Curtis underestimated the savings which could be effected by reducing waste, inefficiency and favouritism and the influence of special interests in government. Personally I believe that tremendous savings could be effected at all levels of government if there were a real will to do so. The effect of public demand as a cause of increased expenditures has been greatly overestimated. In many cases increased expenditures are due to private demand and are neither wanted nor needed by the public.

The last sentence in the paper of Professor Curtis should be graven on the heart of every legislator and public servant:

> "Before acceptance, the case for each new public expenditure should be proven beyond doubt, for in general it is probably true that the best results are obtained by permitting, as far as possible, the individual citizen to spend his own income."

Yours very sincerely,

HORACE L. BRITTAIN.

The Editor, Montreal, 11th May 1939.
The Canadian Chartered Accountant.

Dear Sir:

In this month's issue of THE CANADIAN CHARTERED ACCOUNTANT there appears an article on "Public Finance" written by Professor C. A. Curtis and dealing principally with the question of governmental expenditures. I realize fully the limitations placed upon anyone attempting to deal with such an extensive subject in the space of a short article, but, while I agree with and find interesting Professor Curtis' analysis of the causes of increased expenditures, I find it difficult to agree with his conclusions. To my mind, Professor Curtis is altogether too naîve, too generous, too evasive, when he dismisses with a word the whole question of party politics by saying—"It is doubtless true that in individual cases public moneys have been spent foolishly and even corruptly, but the elimination of every such case will do little to reduce the total of public expenditures." Perhaps Professor Curtis' definition of "foolishly and corruptly" is not so broad as mine, but I would include many notorious weaknesses of our politicians —refusal to face the issue (the railway problem and unemployment relief, to mention only two), playing politics (the policy of not doing anything when you can stay in office by doing nothing), patronage, bad management, and waste far and beyond mere error. It is, I agree, hard to say how much of our total expenditure goes in this way and I would hesitate to make an estimate, but the figure must be very impressive, more impressive, I fear, than Professor Curtis would have us believe.

The discussion of business principles in government administration in this article also falls somewhat short of the mark, I think. In the first place, perhaps parenthetically, successful financial operation may be the chief aim of business, but it is not the only one. There is a growing realization that a business must contribute something to the welfare of the community, must perform a public service, in order to justify its existence, and that it has a responsibility towards its employees for both selfish and unselfish reasons. Secondly, these business principles might be applied more strictly to governmental affairs with salutary effects—be honest in all things beyond the mere letter of the law, get the most for your money, subject of course to the principle of the labourer being worthy of his hire, spend what you have to spend and no more (balanced budgets), keep your word and honour your obligations at all cost, reward your servants according to merit and not otherwise. To say that these principles are not always applied in business would be but begging the question; the fact remains that they are among the better business principles.

I trust that you will not think that I have been prompted to make these remarks in an over-critical spirit. Sooner or later we must face and deal with these facts, and the members of our profession should in their own interest, as well as in that of the country, be prepared to assume their share of the burden.

Yours very truly,
C. W. LEACH.

GENERAL NOTES

The King's English

The 17th May 1939 will go down in history as the memorable day on which the ruling Sovereign of the British Empire visited for the first time one of his self-governing "dominions beyond the seas." At a state luncheon held that day in Quebec City by the Government of the Dominion of Canada, King George VI gave his first address on Canadian soil. He spoke in response to the address of welcome to Their Majesties by Prime Minister Mackenzie King on behalf of the government and the Canadian people, and His Majesty's beautifully-worded message is reproduced here to be read and re-read and long to be cherished:

> Mr. Prime Minister: I am deeply moved by your words of welcome to the Queen and myself on behalf of the Canadian people. I recognize that this moment is historic. It is the first time that a British King has crossed the Atlantic. I stand today on the soil of North America. Here, in the past two centuries, through loss and through gain, the British Commonwealth of Nations has been largely moulded into its present form. This is also the first visit of the sovereign to one of his oversea dominions. It is fitting that it should be to the senior dominion of the Crown. I am particularly pleased that, on the day of my arrival in Canada, I should have the pleasure of meeting not only my Ministers but all the Members of my Privy Council for Canada. You, in Canada, have already fulfilled part of the Biblical promise and obtained dominion from sea to sea. You are now engaged in fulfilling the latter part of that promise in consolidating government from the river to the ends of the earth, from the St. Lawrence to the Arctic snows. The Queen and I are looking forward, with anticipation too great for expression, to seeing all we possibly can of this vast country. Particularly do we welcome the opportunity of greeting the men and women who are its strength and stay, and of seeing something of the younger generation, so soon to become the guardians of its future.

Annual Meeting of 1939

As announced in the April issue, the thirty-seventh annual meeting of The Dominion Association of Chartered Accountants will be held in Saskatoon, Saskatchewan, on August 21st to 24th. Further details of the meeting will be published in our July issue.

Our Contributors This Month

HAROLD BEVERLEY CLEARIHUE who writes on fire insurance accounts this month graduated from the faculty of Commerce and Finance of the University of Toronto in 1932 and became a member of the Institute of Chartered Accountants of Ontario in 1936. He was connected with Thorne, Mulholland and Company, chartered accountants, until 1938 when he became Secretary-Treasurer of Moneta Porcupine Mines Limited, Toronto.

RUSSELL KETTLE, whose lecture "A Few Remarks on Balance Sheets and Profit and Loss Accounts" we publish this month by courtesy of Gee & Co. (Publishers) Ltd., proprietors of *The Accountant*, England, served his articles with Messrs. Deloitte, Plender, Griffiths and Company, and was admitted to the English Institute of Chartered Accountants in 1909. He acted as personal secretary to Lord Plender from 1910 to 1918 and was admitted a partner in Deloitte, Plender, Griffiths and Company in 1919. Mr. Kettle was Chairman of the London Members' Committee of the Institute of Chartered Accountants in 1929.

PROVINCIAL NEWS

MANITOBA

As a compliment to our Dominion President, the last of four business meetings of the members of The Institute of Chartered Accountants of Manitoba took the form of a dinner, at which about fifty members were present. The meeting was held at the Fort Garry Hotel on Monday, 24th April 1939.

Following the dinner, several enjoyable musical numbers were provided by Mr. Ed. Forrest, accompanied by Mr. Herbert Sadler.

Chairman Saul called the meeting to order, and briefly introduced Mr. W. E. Hodge, President of the Dominion Association of Chartered Accountants. In opening a discussion on Dominion Association affairs, Mr. Hodge referred to associations with the Manitoba Institute as far back as 1912. He also paid tribute to Mr. Keith Drennan, who was for many years Secretary of the Institute, in his efforts towards establishing standard examinations, and acknowledged the work which has but recently borne fruit.

Following an interesting and informative outline of the work of the present Dominion Council, Mr. James B. Sutherland on behalf of the Manitoba members proposed a vote of thanks to Mr. Hodge, which was carried with enthusiasm.

OBITUARY

The Late Preble Macintosh, C.A.

The Society of Chartered Accountants of the Province of Quebec regrets to record the death of Mr. Preble Macintosh, which occurred on April 30th.

The late Mr. Macintosh was a partner in the firm of Macintosh, Robertson & Paterson, and was one of the most highly esteemed members of the Quebec Society, having been admitted in 1900 and served on the Council from 1901 to 1903. His passing will be deeply felt by his colleagues and associates.

STOCK BROKERS' ACCOUNTS

Theory and Practice

This series of discussions on the subject of stock brokerage accounting theory and practice has been prepared by a group of members of the profession familiar with the subject. They desire to have it understood that the definitions, opinions and observations appearing in this column are their own and are not necessarily those of the Dominion Association.

(Continued from May issue)

Margin Department and Its Function

The Margin Department of a broker's office records the customers' accounts in such a manner that, at all times (daily in an active market) the margin position of these accounts may readily be determined. A visible cardex system is frequently used, each card representing a customer's account and containing the balance of his account and the position of all securities related thereto. The usual signal tabs may be used to mark accounts for special attention.

By applying the market value of the securities held in any account, the equity on a forced liquidation may be determined and if this equity is sufficient to meet the margin requirements which have been set for the department, then this account is said to be "fully margined." If the equity is not sufficient, then the department must send out a "call" for funds or securities to replace this lost equity. If the call is not met, it is this department's duty to ask a partner of the firm for further instructions.

It is essential for the efficient functioning of this department that its records be kept up to the minute. To

facilitate this, the following forms must first be approved and initialled by the margin department.

1. All requisitions for cheques to customers
2. All customers' orders, and
3. All orders for delivery, transfer, etc., of securities.

Further, copies of all confirmations, cash receipts and disbursements, etc. are immediately given to the margin department for entry.

The importance of this department's work cannot be over emphasized. If clients are permitted to let their accounts remain undermargined or only partly secured, then the broker is actually financing the shortage out of his capital with a consequent risk to the broker.

Arising out of this main function are other duties. It is customary for a broker to require the execution of a margin agreement between himself and his clients before opening a trading account. Special agreements are frequently obtained to cover accounts guaranteed by other clients or outside parties and the release of securities for delivery against short sales of other clients. It is the responsibility of this department to have a record of all such agreements at hand and notify the principals if these have not been received.

Insurance Coverage

Stockbrokers may, in order to protect their capital investment, purchase a variety of bond and insurance coverage. The usual insurance so purchased consists of a Brokers' Blanket Bond which will cover losses occurring through:

1. Dishonesty of employees.
2. Losses of securities occurring inside the office, or on the premises of the insured's bankers, or when lodged for transfer, registration, etc.
3. Losses occurring while the property may be in transit in the custody of either the insured's own messengers, or anyone acting as his messenger.

The stockbroker should also insure himself for losses resulting from the taking as collateral, purchase, sale, or guarantee of endorsement, of invalid securities. Cheque forgery losses should also be covered both on incoming and outgoing cheques or drafts.

A major and frequent source of dishonesty loss to stockbrokers in recent years has been in connection with fraudulent trades on the part of employees. Even the broadest forms of Blanket Bonds differ in the rather limited coverage they provide so that it is necessary for the purchaser of a Brokers' Blanket Bond to read his bond carefully and also have it reviewed by his attorney or an expert in financial insurance in order that he may have some knowledge of the trading losses for which his surety is not liable.

Losses have occurred as the result of collusion between the brokers' employees and employees of other financial firms. This is a very difficult point to cover in a Brokers' Blanket Bond, but should be carefully considered when placing the bond. Instances have arisen where the broker has innocently received securities misappropriated by his client and later found himself liable to return same or their equivalent to the owner.

Brokers who are members of stock exchanges should protect themselves for liabilities which they assume because of the rules of such exchanges in reference to members' liability concerning the introduction of invalid securities into such markets. Members of stock exchanges must, of necessity, be prepared, as the result of such trades with other members, to substitute valid securities for those where the title is called in question. Most of the usual types of invalid securities are included in the coverage of the Securities Blanket Bond, which should be purchased by every stock or bond broker.

TERMINOLOGY DEPARTMENT

The articles in this Department, unless otherwise stated, are originally written by the Chairman of the Terminology Committee and submitted to the members thereof; they are afterwards revised by him after consideration of suggestions made by the members.

If it should be thought that any articles include too much primary or elementary matter, readers are asked to realize that the Committee hopes these articles will be of especial value to Students-in-Accounts; and it is believed that, to impart a thorough understanding, too much emphasis cannot be placed on the fundamental principles on which the ideas connoted in the term defined are based.

(Continued from May issue)

Profits Prior to Incorporation: A company cannot make profits before it comes into existence. Sometimes a company is formed to take over an existing business with rights to the benefit of operations from a date prior to its incorporation; profits made in this interim are known as profits prior to incorporation, and being merged in the assets, are part of the net worth of the business as taken over.

Pro Forma Balance Sheet: pro forma, "for the sake of form" (Lat.). It may be applied in many ways to a balance sheet, e.g., to one drawn up as a suggestion for a form to be used, and which is thus subject to changes according to the ideas of directors or auditors. The most general use of the term, however, is in the case of a balance sheet for use in a prospectus, etc., in which the application of proposed new financing to the business as it stands shows the ultimate position.

Promissory Note: An unconditional promise in writing made by one person called the maker to another called the payee, signed by the maker, promising to pay on demand or at a fixed or determinable future time, a sum certain in money, to or to the order of a specified person, or to bearer (*Bills of Exchange Act*, Section 176).

Property: Anything owned. The word is practically indefinite in extent, and implies anything which a person owns or in which he has an interest.

Proprietorship: The sole ownership of a business. The owner is the "proprietor."

Prospectus: In its wider meaning this term refers to any descriptive circular or pamphlet. Hence the prospectus of a school, a college, book or library. In corporation finance, however, it refers to the circular, advertisement or

other invitation to the public made by a company to subscribe to its share capital or bonds. The following is the definition given in section 73 of *The Companies Act* (Dominion): "Prospectus means any prospectus, notice, circular, advertisement, letter or other graphic communication, offering to the public for subscription or purchase or other acquisition or indicating that there are available for subscription or purchase or other acquisition (and notwithstanding that such communication may state that the securities therein mentioned have been fully subscribed for or sold or that the communication is for the purpose of record only) any securities of a company issued or to be issued by it; provided that a communication in respect of a security shall not be deemed a prospectus (*a*) if it is proved that prior to such communication a prospectus as required by the provisions of this Act was mailed or delivered by or on behalf of the company to the person to whom the communication was made or (*b*) if the communication contains a *bona fide* statement that a prospectus, a copy of which has been filed under the provisions of this Act, will be promptly furnished on request, and contains no statement either of fact or opinion relating to the assets of the company owned or to be acquired, its earnings or prospective earnings, or to any business carried on or proposed to be carried on by it, except a statement specifying the nature of such business."

Protest: A formal statement of dissent or disapproval. As used in the *Bills of Exchange Act*, a written declaration by a notary or justice of the peace that a bill, note or cheque has been presented and payment or acceptance refused.

Provision: A charge against earnings or surplus to establish reserves for undetermined losses or liabilities or the estimated diminution in value of any property, e.g., bad debts, depreciation, income tax, etc. The word "reserve" is usually used in this regard, which often leads to some confusion, in that cases have been known of balance sheets which, under the heading "Reserves," show as a group reserves for depreciation, bad debts, income tax and general. Reserves created by provisions as described should not be so grouped together, but deducted from the book value of the assets concerned, or set up with the liabilities as the case may be.

STUDENTS' DEPARTMENT

R. G. H. SMAILS, C.A., Editor

NOTES AND COMMENT

In the course of two recent lectures[1] delivered at the London School of Economics Professor T. H. Sanders of the Graduate School of Business Administration, Harvard University expressed the opinion (to which he had previously subscribed in "A Statement of Accounting Principles") that the use of secret reserves is not general in the United States except perhaps in the case of banks. He went on to say that it was pretty certain that none of the regulating commissions to which he had referred (the Interstate Commerce Commission, Federal Communications Commission, Securities and Exchange Commission, etc.) would knowingly tolerate the practice. "It is the general feeling," he said, "that earnings and surplus should be fully disclosed, and that if reserves are deemed desirable, they should be appropriated out of surplus and clearly shown on the balance sheet. Even among banking authorities there is some difference of opinion as to whether it would not be better for banks to disclose their situation fully." *The Accountant* (London) in its editorial comment upon the lectures remarked:[2] "It is a little surprising to us to read that in the United States the practice of using secret reserves is not general . . . we rather suspect that what Professor Sanders really means is that the problem of inner reserves has not attracted quite so much attention on his side of the Atlantic as it has on ours because other and more pressing questions fill the landscape; possibly American inner reserves express themselves in another way in the competition between capital surplus and earned surplus which seems so much more urgent and clamant in the United States than it does in England." *The Accountant* may be right in its diagnosis but it is easy to find oneself at cross purposes on the subject of secret reserves unless one has first agreed where "conservatism" ends and secret reserves begin.

* * *

If Lord Bryce had written his "Modern Democracies" today instead of some twenty years ago he would have had

[1]See *The Accountant,* Vol. C, Nos. 3359 and 3360.
[2]Ibid, Vol. C, page 559.

an abundance of material with which to illustrate the autocratic form of government and to point the contrast between it and the democratic form. As it was his illustrations seemed to savour a little of the academic and classical. It is therefore surprising when reading the book today to find how entirely apt those illustrations are and how exactly autocracy follows the traditional pattern. There has been a tendency in some quarters over the past twenty years to belittle Bryce as a political philosopher. A re-reading of his works today is likely to reverse that trend and to elicit admiration for the acuteness of his reasoning and judgment.

* * *

STUDENT ASSOCIATION NOTES

ONTARIO—Toronto

The annual meeting of the Toronto branch of the Chartered Accountants' Student Association of Ontario was held at Hart House, University of Toronto, on April 12th last, and the speaker of the evening was Mr. Aubrey Bond, K.C. Rather than discuss matters of accountancy or business problems and on the theory that a change is as good as a rest Mr. Bond spoke on "A Philosophy of Life", suggesting that it is important that students consider seriously the principles and rules of life and living. Mr. Bond was introduced by Mr. Frank Buck, and Mr. Hennessy presided.

At this meeting Mr. W. G. H. Jephcott, C.A., outlined the recent changes which have been made in the curriculum and in the method of examination, and at the close of the meeting the results of the election for the new council were announced.

Several very successful discussion groups have been held during the past two months, and these groups, which have been well attended, have been of great value to the students. On April 24th Mr. W. H. Moore, C.A., discussed "Some Features of Gold Mine Accounts" with final year students, and on May 1st this group heard Mr. A. R. MacKenzie of Western Flour Mills speak on "The Canadian Grain Trade and Accounting". The intermediate groups were held under the leadership of Mr. K. E. Greenwood, C.A., who, during the course of the meetings, discussed the asset side of the balance sheet in its various aspects; the liability side will be discussed at the meetings to be held in the fall. The primary group concentrated on arithmetic and benefited

from the leadership of Mr. A. R. McMichael, C.A., a former examiner in that subject. Summer weather and baseball have brought these group meetings to a halt, but they will be resumed in the fall.

At the time of writing the baseball league is well under way, and this year ten firms have entered teams. The final game is scheduled for June 29th, and following this it is hoped that a tennis tournament will be organized which will last over a period of two weeks.

The annual golf tournament will be held on June 23rd, followed by a dance in the evening, and the attention of students living outside Toronto is especially directed to this date and a cordial invitation extended to them to be present at the tournament, the dance, or if possible at both.

PROBLEMS AND SOLUTIONS

Solutions presented in this section are prepared by a practising chartered accountant of the Institute from whose examinations the problem is taken and represent his views and opinions. They are designed not as models for submission to the examiner but rather as such discussion and explanation of the problem as will make its study of benefit to the student. Discussion of solutions presented is cordially invited.

PROBLEM I.

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF ONTARIO

INTERMEDIATE EXAMINATIONS, DECEMBER, 1938 ACCOUNTING NO. 1.

Question 7.

The following is the liability side of the consolidated balance sheet of X Company Limited and its subsidiary Y Company Limited as at December 31, 1937, as prepared by the accountant of the parent company:

Consolidated Balance Sheet

X Company Limited

and its subsidiary, Y Company Limited,

as at December 31, 1937

Liabilities

Current Liabilities—		
Bank advances (net)	$ 90,000	
Accounts payable	110,000	
Note payable	50,000	
Sundry accrued liabilities	18,500	
Income and other taxes payable in Canada	20,000	
		$ 288,500

Funded Debt—		
5% bonds of Y Company Limited due January 2, 1940, at par	$ 75,000	
Less—Held by X Company Limited $20,000 par value bonds at 90 plus accrued interest of $500	18,500	
		56,500
Capital Stock—authorized and issued—fully paid:		
Preferred Stock—		
X Company Limited—6%	$500,000	
Y Company Limited—6%	150,000	
		650,000
Common Stock—no par value—		
X Company Limited—25,000 shares	$500,000	
Y Company Limited— 2,000 shares in hands of public—issue value thereof	100,000	
		600,000
Earned Surplus—		
X Company Limited	$300,000	
Less—deficit Y Company Limited	20,000	
		280,000
Excess of issue value of 3,000 shares of Y Company Limited held by X Company Limited over value thereof as shown by books of X Company Limited		15,000
		$1,890,000

The following additional facts are given:

(a) The amount of $15,000 shown as last item above comprises:

Cost of shares to X Company Limited	$150,000
Less—Loss of Y Company Limited since acquisition, attributable to such holdings	15,000
Carrying value	$135,000
Issue value	150,000
Difference	$ 15,000

(b) The common shares of Y Company Limited were all issued to the public at $50 per share and the surplus of Y Company Limited at time X Company Limited acquired the 3,000 shares from the public amounted to $1.00 per share.

(c) The note payable of $50,000 represents a note of Y Company Limited payable to X Company Limited, which company discounted it at the bank.

(d) The inventories of X Company Limited include goods purchased from Y Company Limited at a profit of $10,000 to that company.

(e) The bonds of Y Company Limited were issued at par but the holdings therein by X Company Limited were purchased on the open market at 90.

(f) The parent company has a contingent liability of $25,000 in respect of the guarantee of an account payable by the subsidiary company.

1. Prepare journal entries showing adjustments you would make to the foregoing balance sheet.
2. Prepare working Liability side of the consolidated balance sheet showing adjustments and final figures.

SOLUTION

X COMPANY LIMITED CONSOLIDATED BALANCE SHEET, DECEMBER 31 1937

Liabilities	*Preliminary*		*Adjustments* Dr.	*Adjustments* Cr.	*Final*	
Current Liabilities:						
Bank advances (net)	$ 90,000.00			(6) 50,000.00	$140,000.00	
Accounts payable	110,000.00				110,000.00	
Notes payable	50,000.00		(6) 50,000.00			
Sundry accrued liabilities	18,500.00		(1) 500.00		18,000.00	
Income and other taxes payable in Canada	20,000.00				20,000.00	
Funded Debt:		$ 288,500.00				$288,000.00
5% bonds of Y Company Limited, due January 2 1940, at par	$ 75,000.00				75,000.00	
Less—Held by X Company Limited—$20,000.00 par value of bonds plus accrued interest of $500.00	18,500.00		(1) 1,500.00		20,000.00	
Capital Stock of Subsidiary Company Held by the Public:		56,500.00				55,000.00
Preferred Stock	$			(2) 150,000.00	150,000.00	
Common Stock, at book value	$		(4) 8,000.00	(2) 100,000.00	92,000.00	
Capital Stock — Authorized and Issued, Fully Paid:						242,000.00
Preferred Stock—						
X Company Limited—6%	$500,000.00				500,000.00	
Y Company Limited—6%	150,000.00		(2) 150,000.00			
	$650,000.00					
Common Stock—no par value—						
X Company Limited—25,000 shares	$500,000.00				500,000.00	
Y Company Limited— 2,000 shares in hands of public—issue value thereof	100,000.00		(2) 100,000.00			
	$600,000.00					
Earned Surplus:		1,250,000.00				1,000,000.00
X Company Limited	$300,000.00		(7) 6,000.00	(3) 15,000.00	309,000.00	
Less—Deficit Y Company Limited	20,000.00		(5) 3,000.00	(4) 8,000.00	15,000.00	
		280,000.00				294,000.00
Capital Surplus	$			(1) 2,000.00)		
Excess of Issue Value of 3,000 shares of Y Company Limited held by X Company Limited over value thereof as shown by books of X Company Limited		15,000.00	(3) 15,000.00	(5) 3,000.00)		5,000.00
		$1,890,000.00				$1,884,000.00

ADJUSTING JOURNAL ENTRIES

	Dr.	Cr.
(1) Sundry accrued liabilities	$ 500	
Funded debt	1,500	
To Capital Surplus		$2,000
To deduct accrued interest receivable on bonds from liability therefor on consolidated accounts; to state outstanding bonds at the par value thereof and carry the excess of issue value thereof over cost to Capital Surplus		
(2) Preferred Stock—Y Company Limited	150,000	
Common " —Y " "	100,000	
To Minority interests		250,000
To set up issue value of capital stock of Y Company Limited held by public in Minority interest account — Preferred and Common Stock Y Company Limited		
(3) Excess of issue value of shares Y Company Limited	15,000	
To Earned Surplus X Company Limited..		15,000
To reverse the entry on X Company Limited books whereby the investment in Y Company Limited was written down by X Company Limited share of Y Company Limited loss since acquisition		
(4) Minority interests—Common Stock	8,000	
To Deficit Y Company Limited		8,000
To charge the minority interests with 40% of the deficit of Y Company Limited		
(5) Deficit Y Company Limited	3,000	
To Capital Surplus		3,000
To set up surplus at date of acquisition relative to the 3,000 shares Common Stock Y Company Limited held by X Company Limited		
(6) Notes payable	50,000	
To Bank advances		50,000
To increase liability to the bank in respect of inter-company note discounted		
(7) Surplus	6,000	
To Inventories		6,000
To provide for parent companys' share of inventory profit included in accounts of X Company Limited		

NOTE: It is unnecessary to make any reference on the consolidated balance sheet in respect of the guarantee of an account payable of the subsidiary company since such account payable is included as an actual liability in consolidation.

PROBLEM II.

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF ONTARIO

FINAL EXAMINATIONS, DECEMBER, 1938

Accounting No. 2. Question No. 4

The Balance Sheet of A.B.C. Company Limited, at 31st May, 1938, in summarized form was as follows:

ASSETS

Cash on hand and in banks	$ 5,000.00
Accounts and Bills Receivable, less reserves	810,000.00
Inventories	800,000.00
Plant, less depreciation reserves	2,700,000.00
Goodwill	100,000.00
Deficit	200,000.00
	$4,615,000.00

LIABILITIES

Bank Loan, secured under Section 88	$ 400,000.00
Accounts and Bills Payable	2,000,000.00
Note to Director—payable on 31st May, 1938	15,000.00
Bonds—1st Mortgage 6% bonds	1,400,000.00
Arrears of interest to 31st May, 1938	100,000.00
Capital Stock	
Authorized and issued:	
Preferred:	
6% Redeemable Cumulative 1,000 shares of $100.00 each	100,000.00
(dividends unpaid for 3 years)	
Common:	
60,000 shares of $10.00 each	600,000.00
	$4,615,000.00

The Company arranged a reorganization by the proper procedure replacing existing liabilities and capital in the following manner:

(1) A new group provided $1,000,000.00 additional cash for the business for which they received new 5% first mortgage bonds, repayable $100,000.00 per annum for 10 years.

(2) The indebtedness to the bank was repaid.

(3) General creditors received 25% cash and a new issue of General Bonds for the balance due to them. The new General Bonds were repayable as follows: Interest at 5% per annum, payable in 2nd preferred stock at par for the first five years, at the end of each year, and thereafter quarterly in cash.

Principal repayments to commence after the first mortgage bonds had been repaid—and would then be at the rate of $150,000.00 per annum.

(4) The director's note, with interest at 3% from 31st May, 1938, to be extended for two years.

(5) 1st Mortgage Bondholders to receive one new 1st Preferred share at $100.00 par value for each $100.00 bond, plus the arrears of interest thereon.
The first Preferred Stock to be 5% cumulative and to participate with the second Preferred Stock, on dividends paid on the second Preferred Stock in excess of 3%.

(6) Present Preferred Shareholders to receive new second preferred shares, share for share, and one new Common share for each $10.00 of arrears of dividends. Second Preferred Stock to be 3% non-cumulative—participating with first preferred on 2% additional dividends as available.

(7) Common Shareholders to receive 1/5 share of new no par value common shares for each old share held.
The value set for the new common shares of no par value to be $1.00 per share and any surplus resulting from the reorganization to be applied first in reduction of the intangible assets, and secondly in reduction of the book value of plant.

(a) Outline the procedure required for the company to obtain authority for the reorganization.

(b) Give the Journal Entries to give effect to the reorganization and prepare the new Balance Sheet on completion of reorganization.

(c) The operating profits of the company during the subsequent 3 years, excluding all financial charges, were as follows:

Year ended 31st May, 1939—$150,000.00
31st May, 1940— 200,000.00
31st May, 1941— 500,000.00

The directors declared dividends when profits were available.

Prepare a summary of the Profit and Loss and Surplus Accounts for each of the three years.

SOLUTION

The following journal entries give effect to the transactions resulting from the reorganization of the Company:

1. Bank	$1,000,000.00	
To First Mortgage 5% Bonds, new issue		$1,000,000.00
To record receipt of cash and issue of $1,000,000.00 in bonds.		
2. Bank Loan secured under Section 88 of the Bank Act	400,000.00	
To Bank Disbursement		400,000.00
To record repayment of Bank Loan.		
3. Accounts and Bills Payable	2,000,000.00	
To Bank Disbursement		500,000.00
To General 5% Bonds		1,500,000.00
To record settlement of General creditors by cash payment of 25% of claims and issue of General 5% bonds for balance due them in accordance with arrangement approved by shareholders and Court.		

4. First Mortgage 6% Bonds (Old issue)	1,400,000.00	
Arrears of Interest on First Mortgage 6% Bonds to 31st May 1938	100,000.00	
To Old Bondholders		1,500,000.00
To record cancellation of Old First Mortgage 6% Bonds and arrears of Interest to 31st May 1938.		
5. Old Bondholders	1,500,000.00	
To First Preferred 5% Cumulative Participating Capital Stock		1,500,000.00
To record issue to Old Bondholders of 15,000 First Preferred 5% Cumulative Participating Shares of $100.00 par value in settlement of claims of Old First Mortgage Bonds and arrears of interest thereon in accordance with agreement dated ....1938, approved by the shareholders and by Supplementary Letters Patent dated...........1938.		
(One share of First Preferred Stock issued for each $100.00 Old First Mortgage Bond held, plus the arrears of interest thereon.)		
6. Old 6% Redeemable Cumulative Preferred Shares	100,000.00	
To New Second Preferred 3% Non-Cumulative Capital Stock		100,000.00
To record issue of 1000 New Second Preferred 3% non-cumulative participating Capital Stock of $100.00 par value each in exchange for 1000 old 6% Redeemable Cumulative Preferred Shares, share for share, as per agreement, dated approved by shareholders and confirmed by Supplementary Letters Patent dated ....1938.		
7. Surplus on Reorganization	1,800.00	
To New Common Capital Stock of No Par Value		1,800.00
To record issue of 1800 shares of Common Stock of No Par Value in settlement of arrears of dividends on old 6% Cumulative Preferred shares on basis of issue of one New Common share for each $10.00 of arrears of dividends.		
8. Old Common Shares	600,000.00	
To New Common Capital Stock of No Par Value		12,000.00
Surplus on Reorganization		588,000.00

To record exchange of 60,000 Old Common shares of $10.00 each for 12,000 New Common shares of No Par Value issued at $1.00 per share in accordance with agreement with shareholders and Supplementary Letters Patent dated ....1938.
The exchange basis is 1/5 New Common Shares for each Old Common Share held.

9. Surplus on Reorganization	586,200.00	
To Deficit Account		200,000.00
Goodwill		100,000.00
Plant		286,200.00

Surplus on Reorganization applied to write off the balances in Deficit and Goodwill accounts and the balance applied in reduction of the book value of Plant.

A. B. C. COMPANY LIMITED
BALANCE SHEET AS AT 31st MAY, 1938
ON COMPLETION OF REORGANIZATION

ASSETS

Current Assets:		
Cash on hand and in Banks ....$	105,000.00	
Accounts and Bills Receivable, Less Reserves	810,000.00	
Inventories	800,000.00	
		1,715,000.00
Fixed Assets:		
Plant		2,413,800.00
		$4,128,800.00

LIABILITIES

Funded Debt:		
Note payable to Director—@ 3% interest, due 31st May 1940 .... $	15,000.00	
First Mortgage, 5% Bonds, repayable $100,000.00 per annum	1,000,000.00	
General Mortgage 5% Bonds (Interest payable in First Preferred stock for 5 years)		
Principal repayable $150,000.00 per annum commencing after the first mortgage bonds have been retired in full	1,500,000.00	2,515,000.00

Capital Stock—Authorized and Issued—fully paid:		
First Preferred 5% Cumulative Shares participating with second preferred dvidends in excess of 3% 15,000 shares of $100.00 each	1,500,000.00	
Second Preferred 3% Non-Cumulative Shares (Participating with first preferred additional 2% as available) 1,000 shares of $100.00 each	100,000.00	
Common Shares 13,800 shares of no par value	13,800.00	1,613,800.00
		$4,128,800.00

PROFIT AND LOSS ACCOUNT
FOR THE YEAR ENDED 31st MAY, 1939

Operating Profit for Year		$150,000.00
Deduct: Financial Charges		
Interest on Director's Note 3% of $15,000.00.	$ 450.00	
Interest on Bonds		
First Mortgage Bonds 5% on $1,000,000.00	50,000.00	
General Mortgage Bonds 5% on $1,500,000.00 payable by issue of 750 shares 1st Preferred Stock	75,000.00	
		125,450.00
Net Profit for year carried to Surplus Account		$ 24,550.00

SURPLUS ACCOUNT

Balance from Profit and Loss Account being profit for the year ended 31st May 1939	$ 24,550.00

PROFIT AND LOSS ACCOUNT
For the Year Ended 31st May, 1940

OPERATING PROFIT FOR YEAR			$200,000.00
Deduct: Financial Charges			
Interest on Director's Note 3% $15,000.00		$ 450.00	
Bond Interest			
First Mortgage 5% Bonds 5% on $900,000.00	45,000.00		
General Mortgage 5% Bonds 5% on $1,500,000.00 ...... payable by issue of 750 shares 1st Preferred Stock	75,000.00	120,000.00	120,450.00
Net Profit for the Year carried to Surplus Account			$ 79,550.00

SURPLUS ACCOUNT
For the Year Ended 31st May 1941

Balance 31st May 1939	$ 24,550.00
Profit for year ended 31st May 1940	79,550.00
	$104,100.00
Deduct: Arrears of Dividend at 5% on $1,500,000.00 First Preferred Stock for the year ended 31st May 1939	75,000.00
Balance 31st May 1940	$ 29,100.00

PROFIT AND LOSS ACCOUNT
For the Year Ended 31st May, 1941

OPERATING PROFIT FOR YEAR		$500,000.00
Deduct: Financial charges		
Bond Interest		
First Mortgage Bonds		
Interest at 5% on $800,000.00	$ 40,000.00	
General Mortgage Bonds		
Interest at 5% on $1,500,000.00 (Payable by issue of 750 shares 1st Preferred Stock)	75,000.00	115,000.00
Net Profit for Year carried to Surplus Account		$385,000.00

SURPLUS ACCOUNT
For the Year Ended 31st May, 1941

Balance 31st May 1940				$ 29,100.00
Profit for the year ended 31st May 1941				385,000.00
				$414,100.00
Deduct:				
Dividends on First Preferred Stock:				
Arrears of Dividend for year ended May 31st 1940, 5% of	$1,575,000.00		$ 78,750.00	
Regular Dividend 5% of	$1,650,000.00		82,500.00	
Participating Dividend of 2% of	1,650,000.00		33,000.00	
			$194,250.00	
Dividends on Second Preferred Stock:				
Regular Dividend of 3% of	$100,000.00	$3,000.00		
Participating Dividend of 2% of	100,000.00	2,000.00	5,000.00	199,250.00
Balance 31st May 1941 available for Dividends on Common Shares				$214,850.00

Note: Provisions for Income Taxes have been omitted as the question does not state in what provinces the company operates, and such provision would have to be a rough estimate.

THE

CANADIAN CHARTERED ACCOUNTANT

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OF
SUBJECTS AND CONTRIBUTORS

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(ISSUED AS A SUPPLEMENT TO THE JUNE 1939 NUMBER)

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